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THE 1984 MIDYEAR ECONOMIC OUTLOOK

HEARINGS

BEFORE THE

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CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

SECOND SESSION

JULY 30 AND AUGUST 2, 3, AND 8, 1984

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THE 1984 MIDYEAR ECONOMIC OUTLOOK

MONDAY, JULY 30, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SD-106, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen and D'Amato; and Representatives Hamilton, Scheuer, and Holt.

Also present: Dan C. Roberts, executive director; James K. Galbraith, deputy director; Charles H. Bradford, assistant director; and William R. Buechner, Robert R. Davis, Paul B. Manchester, and Sandra Masur, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Chairman Volcker, it's a pleasure to welcome you again before the Joint Economic Committee.

I think I can speak for all the members of this committee on both sides of the aisle, when I say that I was heartened by your testimony before the Senate Banking Committee last week. It is finally becoming clear, even to the most skeptical observers, that the economy has made unprecedented gains in 1983 and 1984. In your words, "The measures of aggregate economic activity, employment costs, and prices have provided an almost unbroken string of favorable news." And, you brought the good news that the members of the Federal Open Market Committee share the view that economic growth and inflation will continue to be well-behaved through 1985.

Your comments on monetary policy were just as important. You indicated a renewed commitment to monetary stability that will maintain progress toward stable prices without unduly hampering a complete recovery by the economy. The reinstatement of the M1 target also implies a reduced emphasis on interest rate manipulations. The positive response of the financial markets last week is testimony to the wisdom of this announced direction of policy and is, I think, very heartening. The task at hand now is to deliver.

The last 2 years provide ample evidence that real economic growth is not inflationary. Also budget deficits, as dangerous as they are, are not inherently, by themselves, inflationary. However, I share the view that budget deficits cannot be ignored. Even though the deficit has fallen over 10 percent from last year's level, we cannot rely exclusively on growing tax revenues from the economic recovery if Congress continues on a spending spree. Federal

spending remains at record high levels across the board, while taxes have been contained near the historical average. As you noted last week, our economic prospects improve greatly if we can control the urge to spend. If we continue to borrow or raise taxes to fund high spending, we will literally kill the goose that lays the golden egg.

Some trouble spots in the economy are close to our hearts. Agriculture is one that is close to our stomachs as well. It is high time that we afford the same concern to the agricultural community that has been afforded to the credit problems of developing countries. I was encouraged by your endorsement of procedures that provide leeway for banks to restructure troubled agricultural loans. They need that latitude in these troubled times in the Midwest and other areas of the country. This policy will go a long way toward preserving the American farmer, the most productive farmer in the world.

Once again the ball is in both of our courts. The Federal Reserve must pursue a stable policy to control inflation and avoid unnecessary cyclical disturbances. The Congress must work with the executive branch to fashion a fiscal policy that provides a basis for long-run economic growth. We have made strides in both directions. The American people are still waiting and deserve even more. I trust that we can build on our progress in the future.

Mr. Chairman, your remarks will be entered into the record as if read. I am anticipating that there will be several members of the committee who will have some opening statements. They will be entered in the record as they present them.

At this time, Chairman Volcker, you may proceed with yours. Thank you for coming.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman.

I am pleased to appear before this committee again.

I have a statement which resembles rather closely the statement I delivered last week before the Banking Committee, in which I do note that this recovery has been remarkably favorable in its strength and so far in its relatively subdued inflationary pressures. I also emphasize rather strongly in the statement that there are strains, pressure points, risks that I think demand attention and correction, if that record is to be continued.

There is, in particular, as you mentioned, a large—I think it has to be called massive—imbalance in our fiscal condition, and related to that, in considerable part, an imbalance in our international trading accounts. We've also had some strains in financial markets.

You mention that the budget deficit appears to be down this year by about 10 percent. I think that's correct, but it comes from an extremely high level and reducing it by 10 percent is frankly not enough as we get into a period of high employment, reduced unemployment, rising credit demands from other sectors of the economy. I don't think we have to look any further than that set of circumstances to see why interest rates are so high. That not only puts current pressures on the markets but also continues to engender

concerns about whether inflation may go up appreciably in the years ahead.

Of course, we want to avoid that in terms of maintaining sustained and sustainable growth.

Monetary policy is reviewed on several pages in my prepared statement and, as you indicated, members of the Open Market Committee and the Federal Reserve Board have projected continuing growth next year in the neighborhood of 3 percent. They've also projected some moderate increase in the inflation rate, on the assumption that the dollar remains somewhere in its recent trading range. But I must emphasize that while those projections reflect the central tendency of thinking, they also reflect, underneath the surface, that there are very substantial risks to the outlook, risks reflected in those large trade imbalances, the massive budgetary deficits, the strains on financial markets internationally.

We did not change the monetary targets for this year. We indicated some small declines next year in M1 and M2, reflected in a decrease in the top end of the ranges for both of those aggregates.

As far as the international financial situation is concerned, there has been, I think it's fair to say, increased uncertainty over the spring, ironically coming at a time when there are signs of progress among some of the major debtor countries. Those signs of uncertainty have been related to the increases in interest rates and to the indications of protectionist pressures in the United States and elsewhere, both of which are extremely troublesome in terms of the outlook for that area of the world and that area of the financial system.

That whole problem is going to take very strong continuing efforts to contain and manage. I do think it is manageable, but I don't think there should be any illusion that there is simple, straightforward, even progress. I don't think it justifies the degree of optimism that may have been expressed some time ago, nor does it justify despair. It does justify continuing hard work and effort.

I bring you a somewhat mixed report, Mr. Chairman. Certainly, overall, economic performance has been exceptionally favorable over the past year, combining strong growth with a better price performance, but there are obvious strains, imbalances, and risks that could undercut much of what's been achieved.

The only real question is whether we as a nation will deal with them properly and forcefully with constructive public policies, policies that are consistent with long-term growth and stability, or whether we will be content, despite all the strains and dangers, to let events simply take their course. If we indulge in shortsighted relapses into lack of financial discipline or widespread protectionism or wage and pricing excesses, the situation can only be aggravated.

Let me say none of those problems will be cured by attempts to drive interest rates down artificially by excessive money creation. The inflationary repercussions could only aggravate the situation. In the end it's a choice between building on the enormous progress of the past to achieve sustained growth in a framework of greater stability or a relapse into an inflationary economic malaise.

With that choice clear, I am confident that the needed policies are within our collective grasp. In the areas of our responsibility,

both monetary and supervisory policies, we are working toward achieving stability and growth, and we count on progress in other directions as well.

The facts with respect to growth and inflation for more than a year demonstrate that we all have much on which to build, but there are also clear signals that far from basking in the warmth of past and present progress, we must undertake the strongest kind of effort to convert potential success into sustained growth and stability.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Volcker follows:]

PREPARED STATEMENT OF HON. PAUL A. VOLCKER

I appreciate the opportunity to appear once again before the Joint Economic Committee. As you know, the Federal Reserve submitted to the Congress last week its semi-annual report required under the Humphrey-Hawkins Act, which reviewed economic developments and the decisions of the Federal Open market Committee with respect to monetary and credit targets for 1984 and 1985. My prepared remarks this morning, therefore, will be brief and confined to more general considerations of monetary policy in the context of our overall economic performance and the problems that present evident risks to an otherwise positive outlook.

The Overall Economic Performance

Measures of aggregate economic activity, employment, costs, and prices have provided an almost unbroken string of favorable news so far in 1984. The process of recovery from the deep and prolonged recession--a recovery that began amid widespread doubts about both its potential vigor and staying power--had proceeded strongly through 1983. There were widespread anticipations early this year that, as we moved beyond the initial recovery into a new expansion phase, the pace of growth would slow. But, in fact, growth actually accelerated as we moved into this year. During the first half of 1984, the economy as a whole grew at nearly a 9 percent annual rate, compared with a 6-1/2 percent pace during 1983. In addition, almost three million more people have been employed so far this year, bringing the total gains over the past 18 months close to 7 million, and the unemployment rate has dropped to about 7 percent.

Much of the strength in economic activity this year has come from consumer spending, as unit auto sales in the first half rose to the highest level since mid-1979. With real income growth strong and consumer confidence high, the demand for other big ticket items -- such as furniture and appliances -- also has been robust. In the business sector, sales and profits have been rising rapidly, prompting a vigorous expansion in outlays for new plant and, particularly, equipment. The widespread need for acquiring new electronic and data processing technologies has continued to provide an element of strong demand for investment in capital goods. Potentially, this investment will be reflected in rising productivity, although the extent to which the trend of productivity growth is rising faster than during the late 1970's is still not clear.

Despite the surprising strength of activity this year, inflationary pressures (as measured by most summary price measures) have to this point remained subdued. In fact, a number of sensitive commodity prices have dropped recently, following sizable cyclical increases. Highly competitive domestic and international markets, influenced by the strength of the dollar overseas and continued strong efforts to discipline costs, have been key factors contributing to greater price stability. The net result has been rising productivity and good gains in real income, even while increases in nominal wage rates have remained moderate.

Looking only at these overall measures, this recovery and expansion period has been atypical -- atypical in the sense that rapid expansion has been maintained longer after the recession

trough than in any comparable cyclical period since World War II, excepting only the Korean War episode. But the period has been atypical in other ways as well -- in ways that potentially will have severely adverse implications unless dealt with by timely and effective policy action.

Imbalances and Strains

In any period of recovery and expansion, some sectors fare relatively better or worse than others, and in that general respect this period has been no exception. What is different, in degree and in kind, is that some inevitable unevenness in patterns of growth in particular sectors has been aggravated by the massive and related imbalances in both our fiscal position and our international trading accounts and by some strains in financial markets.

As you know, rapid growth has been reflected in some reduction in the budgetary deficit, estimated for fiscal 1984 in the neighborhood of $170-$175 billion. The Congress is in the process of enacting the so-called "downpayment" against future deficits, part of which has already been signed by the President. But the hard fact is, as I am sure the Congress is fully aware, the deficit remains huge in absolute and relative terms. Absent further action, little or no further decline now seems probable for 1985 and beyond. Indeed, we cannot rule out that the deficit could be higher next year, even assuming the economy continues to move toward "full employment" levels.

That circumstance has been reflected in continued large Treasury borrowings, and expectations of indefinite continuation. Meanwhile, private credit demands, responding to and supporting

growth in consumption and investment, have accelerated. But the sources of domestic funds supplied to credit markets have fallen far below our combined public and private demands for credit. In these circumstances, interest rates -- already historically high -- tended to move still higher during the spring.

Those high interest rates, combined with favorable economic conditions generally in this country, have attracted more and more capital from abroad to help meet our domestic financing needs, and the dollar has appreciated despite deterioration in our trade and current accounts. The strong dollar certainly has been a potent force helping to contain inflation and reduce pressures on our financial markets. But what is in question is the sustainability of that process as the United States becomes more and more dependent on foreign capital, as our export and import-competing industries are damaged and seek protectionist relief, and as interest rate pressures remain strong. In that sense, we are literally living on borrowed time.

The continuing difficulties of some heavily indebted developing countries in Latin America, and in some other places as well, has been another point of uncertainty. A sense of greater concern has, ironically, come at a time when several of the largest borrowers have more clearly made substantial progress toward reducing external financing requirements and toward carrying out the more fundamental adjustments that should provide a firm base for their renewed growth.

That sense of concern has been related importantly to both the increases in interest rates over the spring, and to fears of protectionist measures damaging the capabilities of the indebted countries to export. Put another way, the related deficits -- budgetary and trade -- place heavy pressure on the international financial and trading systems -- pressures that can only be dealt with by attacking the source of the problem.

Within the United States, the relatively high level of interest rates has aggravated financial strains in the farm sector. Many thrift institutions face the prospect of weak earnings at a time when capital positions have been eroded by losses earlier in the decade. And, despite the rapid growth of the economy and strong increases in business profitability overall, more stable prices have exposed some weaknesses in credit practices of banks and others in the energy and other areas encouraged by earlier inflationary expectations.

Monetary Policy

These developments have provided the setting for the implementation of monetary policy thus far in 1984 and for the review of monetary and credit objectives by the Federal Open Market Committee for this year and next.

In reaching its policy judgments, the Committee members shared the widespread view that the overall rate of economic growth would moderate soon, as resources become more fully employed, and would continue through 1985 at a sustainable pace. While the rate of price increase has been somewhat slower than expected

over the first half of 1984, that rate is generally expected to rise by a percentage point or so next year, assuming that the dollar remains in the same general range as over the past year. In making those projections, which are detailed in Table I attached, Committee members also noted that the continued high budget deficits and other factors noted earlier, unless dealt with effectively, would pose substantial risks of less satisfactory results with respect to economic activity or prices or both. In that sense, the projections should not be taken to assume that satisfactory results are assured, absent policy adjustments.

The economic projections, of course, took account of the decisions made on monetary policy. Broadly, monetary policy will remain directed toward providing enough money to support sustainable growth while continuing to encourage greater price stability over time. As detailed in the full report, Committee members felt that broad objective was consistent with the growth ranges for money and credit specified in February for this year, and no changes were made. For 1985, the tentative decision was reached to reduce the ranges slightly for both M1 and M2, specifically by lowering the top end of the ranges specified for this year by 1% and 1/2%, respectively. The target range for M3 and the monitoring range for domestic credit were left unchanged. These tentative decisions for 1985, reflected in Table II attached, will be carefully reviewed at the start of next year.

The Committee also reviewed the relative weights to be placed upon the monetary aggregates, and felt that roughly equal weight should be given each of them in implementing policy. However,

appraisal of their movements, and relationships among them, will continue to be judged in light of developments with respect to the economy, domestic and international financial markets, and price pressures.

Although both M1 and M2 have grown within their targeted ranges this year, M3 and particularly domestic credit, have expanded faster than anticipated. Credit growth has, in fact, continued to outpace that of nominal GNP, as was the case last year but contrary to longer-term trends. Growth in the business component of nonfinancial credit has been amplified by an unusual spate of merger actvity and corporate financial reorganizations -- so-called "leveraged buy-outs" -- that had the effect of substituting debt for equity. The implications of those financings, while potentially adverse from the standpoint of the overall financial strength of particular businesses, are relatively neutral from the standpoint of demands on real resources and overall credit market conditions. Estimated adjustments for that activity on the rate of overall credit growth would reduce the indicated expansion over the first half of the year from a rate of about 13 percent to 12 percent, closer to, but still above, the monitoring range. That growth, together with the extraordinary rise in consumer and federal government debt, is shown in Table III.

In implementing the policies reflected in the various targets, steps were taken during the late winter and early spring to increase somewhat pressures on bank reserve positions, and the discount rate was raised once, from 8-1/2 to 9 percent. Reserve

pressures have not changed appreciably since that time, as reflected in relatively unchanged borrowings at the discount window (apart from those by the troubled Continental Illinois Bank). With both M1 and M2 remaining within their target ranges, and against the background of the economic, price, and financial market developments reviewed earlier, stronger restraining actions on money and credit growth generally have not appeared appropriate. At the same time, the relatively rapid rates of growth in M3 and domestic credit are flashing cautionary signals.

While pressures on bank reserves did not increase further, both long- and short-term interest rates rose over the spring. The continued heavy credit demands, expectations that those demands would persist against the background of the huge federal deficit and strong economic expansion, and fears of a resurgence of inflationary pressures as both labor and capital are more fully employed all played a part. In more recent weeks, rates have tended to stabilize at high levels, perhaps partly because current price trends have, at least so far, not borne out more extreme inflationary concerns expressed earlier. Nonetheless, markets remain volatile and apprehensive.

Banking Markets

The atmosphere surrounding credit and banking markets at times during recent months has been appreciably influenced by the apparent difficulties of one of the nation's largest banks and by continuing concerns over the ability of some developing

countries to service debts held mainly by large commercial banks around the world.

As I have reported to the Congress before, orderly and full resolution of the latter problem will require a strong cooperative effort by borrowers and lenders alike over a considerable period of time. As I noted a few minutes ago, the difficult process of internal and external adjustment is beginning to bear fruit in important countries in Latin America, including Mexico, Venezuela and Brazil. In other countries the adjustment process is less advanced, but the progress of some, both in adjustment and financing, can point the way for others. While the challenge for all remains substantial, with effort on all sides, the problem is manageable.

Recent concerns about strains on our banking institutions have focused on the problems of Continental Bank. That situation is unique for a large bank, but the episode may be an object lesson for all of us concerned with maintaining the strength of the financial system. In a period of rapid economic expansion, there can be temptations to relax credit standards in an effort to maximize growth. Bank managers need to appraise the risks prudently, taking full account of the possibility of a more adverse economic and interest rate environment. That, of course, is and should be the customary policy of banks, and I sense that some have reviewed their practices to make sure they are appropriate in today's circumstances.

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Conclusion

Indicators of overall economic performance have been exceptionally favorable for more than a year. So far, a strong economic expansion has been consistent with better price performance than we have enjoyed for many years.

At the same time, there are obvious strains, imbalances, and risks that could undercut much of what has been achieved. The only real question is whether we as a nation will deal with them promptly and forcefully with constructive public policies, consistent with long-term growth and stability, or whether we will be content, despite all the strains and dangers, to let events simply take their course. Short-sighted relapses into lack of financial discipline, widespread protectionism, and wage and pricing excesses could only aggravate the situation.

None of these problems will be cured by attempts to drive interest rates down artificially by excessive money creation; the inflationary repercussions could only aggravate the situation. Nor can distortions arising from other sources be dealt with effectively by any general monetary measures.

It is, in the end, the choice between building on the enormous progress of the past to achieve sustained growth in a framework of greater stability or a relapse into inflationary economic malaise. With that choice clear, I am confident that the needed policies are well within our collective grasp.

In the areas of our responsibility -- both monetary and supervisory policies -- we are working toward achieving stability and growth. We count on progress in other directions as well. The facts with respect to growth and inflation for more than a year demonstrate that we all have much upon which to build. But there are also clear signals that -- far from basking in the warmth of past and present progress -- we must undertake the strongest kind of effort to convert potential success into sustained growth and stability.

Table I

Economic Projections for 1984 and 1985*

	FOMC Members and other FRB Presidents	
	Range	Central Tendency
1984		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	9-1/2 to 11-1/2	10-1/2 to 11
Real GNP	6 to 7	6-1/4 to 6-3/4
Implicit deflator for GNP	3-1/4 to 4-1/2	4 to 4-1/2
Average level in the fourth quarter, percent:		
Unemployment rate	6-1/2 to 7-1/4	6-3/4 to 7
1985		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	6-3/4 to 9-1/2	8 to 9
Real GNP	2 to 4	3 to 3-1/4
Implicit deflator for GNP	3-1/2 to 6-1/2	5-1/4 to 5-1/2
Average level in the fourth quarter, percent:		
Unemployment rate	6-1/4 to 7-1/4	6-1/2 to 7

*The Administration has yet to publish its Mid-session Budget Review document, and consequently the customary comparison of FOMC forecasts and Administration economic goals is not included in this report.

Table II

Growth Ranges Reconfirmed for 1984 for Money and Debt
Compared with Actual Growth through June '84

	Ranges	Actual Growth QIV '83 to June '84
M1	4 to 8	7.5
M2	6 to 9	7.0
M3	6 to 9	9.7
Debt 1/	8 to 11	13.1 e/

Note: Growth ranges pertain to period from QIV '83 to QIV '84.

e/ Estimated.

Tentative Growth Ranges Adopted for 1985

M1	4 to 7
M2	6 to 8-1/2
M3	6 to 9
Debt 1/	8 to 11

Note: Growth ranges pertain to period from QIV '84 to QIV '85.

1/ Domestic nonfinancial sector debt.

Table III

GROWTH IN DOMESTIC NONFINANCIAL DEBT
(Seasonally adjusted annual rates, percent)

	QIV: 1983 to QII: 1984 1/
Total	13.1 2/
Federal	14.6
Other	12.6
Selected Categories	
Home Mortgages	11.7
Consumer Credit	18.4
Short-term Business Borrowing	15.6

1/ Based on quarterly average flow of funds data. QII: 1984 partly estimated.

2/ Adjusted for the credit used in corporate mergers and buyouts, it is estimated that growth in domestic non-financial debt would be about 12 percent (SAAR) over the first half of 1984.

Senator JEPSEN. Thank you, Chairman Volcker.

Suppose the Federal Reserve revealed the nature of the policy decisions they make shortly after they are formulated. I know we've talked about this before. I'd like you to comment on it again. What effect would this have on markets? Wouldn't the public be able to make more efficient decisions regarding employment, saving, investment, production, consumption, future planning, if the Fed released more information sooner? Wouldn't it mean that the public would spend less time and money trying to discover the intent of the policy?

Now today we've had this brief discussion of the Federal Open Market Committee meeting ending just a few days ago, and I would point out that in the last week in February, the nature of the Federal Open Market Committee decision was revealed at the Humphrey-Hawkins hearings. The markets did not react adversely then, and I suspect the reaction will be minimal today and tomorrow. If we release the Federal open market decisions quickly on these occasions, why can't we do it all the time, or why don't we do it all the time?

Mr. VOLCKER. In approaching that question, Mr. Chairman, I would make a distinction between what I think of as policy decisions and what I think of as an operational implementation of those decisions. When we do make a general policy decision, it's typically announced very promptly and immediately. These hearings today and last week are reflective of that, twice a year we give our monetary targets and any general approaches or changes in approach that are suitable on that occasion. We've done that for some years, as you know.

If we make a change in the discount rate, a discrete movement on reserve requirements, we announce it. I think that is a perfectly appropriate procedure, that we indicate our general direction and announce a policy decision. We are not confined to these semiannual Humphrey-Hawkins occasions for making such announcements.

Our meetings every 6 or 8 weeks are in the nature, generally, of operational decisions. The decisions on the degree of pressure on bank reserve positions that are in the nature of implementing a policy that's already been laid down are often of a contingent nature. They depend on what happens during that period. No one can foresee the range of economic, price, and credit developments that may happen, that may cause those operational decisions to vary even between meetings. Those decisions are very frequently of a contingent nature.

My very strong feeling, on the basis of the experience I've had in this business over many years, is that it would create more confusion than help to reveal operating decisions of that kind. These are basically contingent decisions, made very frequently, that if announced immediately will lead to misunderstanding in the market, will lead to reactions in the market, and we will find ourselves reacting to market reactions to our statements, rather than to the facts as they unfold.

I am not aware of serious difficulties that arise in this connection as a result of our present procedure. I think it has been a practice which has been followed regularly through the years. I happen to think it is an approach that leads to the best results.

Senator JEPSEN. Chairman Volcker, the graph on your left and on my right shows the 6-month growth rates of M1 that determine the level of nominal GNP about two quarters later. Changes in money growth have pushed the business cycle up and down. M1, as we know, is driven up and down by changes in the bank reserve growth, which the Fed controls. As you know, we visited in May concerning the months of March and April and discussed the fact that early on this year, with the inventory buildup, which was approximately $30 billion compared to $9 billion the quarter before, $7 billion before that, for a combination of reasons, there was increased demand and credit. At the same time the bank reserve changes back in March and May were in the area of, I believe—correct me—the figure was somewhere in the neighborhood of 3 percent in March, then in April, 0. They drove the reserve changes interest rates up. Now, in your remarks you say that as well.

Most everything you said I certainly concur with, and as you know, over the years, I have supported that there would be some drastic devastating results, if we succumb to a wave of protectionism.

But you also indicated that you felt the need to drive interest rates, you manipulate them—I think your words were—by artificial money manipulation. What do you mean by artificial money manipulation? Would 3-percent growth or 0-percent growth be called manipulation?

Mr. VOLCKER. What I meant by artificial money manipulation in that context was an effort to push the money supply higher than seems appropriate—in terms of longer term criteria and our basic objectives for the economy—in an effort to get interest rates down over some short time period. I don't believe in the present circumstances that this approach could be successful, even in its nominal objective, for very long.

If I may just comment on a couple of the observations you made. You say the money is controlled by our reserves. We allow some elasticity there; traditional arrangements allow some elasticity. I would rather say that money supply growth is determined by a combination of supply factors, which we certainly influence, and the demand for money in the economy and reserves are certainly not the only or, over a period of time, the prime influence on interest rates directly.

You correctly point out, that we increased the pressures on bank reserves somewhat in the early spring or late winter. Interest rates went up during the spring when our approach was basically unchanged. I think that that reflects supply and demand factors in the market, particularly the extraordinarily rapid growth in credit that we have had during this period.

Total credit has increased at an annual rate of about 13 percent during the first half of the year. That's a combination of very heavy Government demands with rising private credit demands. When you have that kind of credit growth, which I think is clearly in excess of what is healthy over a longer period of time, I think you can expect pressures on interest rates.

Senator JEPSEN. The Chair advises the panel we're going to try and limit it to 5 minutes and we'll go back around as people come in here.

Senator D'Amato, you may proceed.

Senator D'AMATO. Thank you very much, Mr. Chairman.

Chairman Volcker, just recently the massive bailout of Continental Illinois has been revealed with the FDIC's action of acquiring $4.5 billion of Continental's loans as well as $3.5 billion in debt owed to the Federal Reserve Bank of Chicago. My question is what would have been the affect on the market place if the FDIC had not guaranteed all deposits over $100,000?

Mr. VOLCKER. That decision was taken, as you know, in May with the interim program that was announced at that time and in a situation of some uncertainty related to the international financial pressures in particular. I think the sudden failure of a large bank of that sort with frozen deposits, if not eventual losses on deposits, could clearly have had influences rather directly on the depositors involved and there are a good many depositors involved, including a good many other banks around the country. In that particular market situation, it would have raised questions about whether pressures would extend to other banks that might be fundamentally in a much more solid position than Continental Illinois was.

Senator D'AMATO. Let me ask you this. In light of the weakness that became apparent 2 years ago of Continental Illinois, after the Penn Square debacle, do you think the regulators were rather slow in reacting to the problem? Especially given the statements of the then chairman of the board who indicated that they were going to continue to be aggressive despite the Penn Square fiasco.

It just seems to me that the FDIC moved in 2 years late. The Federal regulators have not been doing their job and allowed the bank to continue its irresponsible lending activities. I know the money center banks aren't going to be happy to hear the Senator from New York say this, but the regulators should be more restrictive in allowing banks to lend so much money so easily.

Furthermore, it is wrong that these loans to Third World nations are carried at book value. Also, banks should not be able to report earnings on loans when the interest is paid from new loans. These earnings should not be reported to stockholders.

I just think that the Federal regulators have done a miserable job in allowing the banking to get to this point of weakness. This is contributing to high interest rates. Investors are demanding a premium on deposits because of the weakness of the banking system.

Mr. VOLCKER. I find myself in disagreement with your observations.

Senator D'AMATO. You think the regulators have done a good job by allowing the banks to become this weak?

Does anyone think that Poland is going to pay us back or that Argentina in the near future is really going to pay us back, I'd like you to answer that. You answer that question. Do you really think these countries will repay their foreign debt?

Mr. VOLCKER. I think these countries are not in a position to pay these loans back in large volume in the period, in the foreseeable period ahead, but that is not to say that they cannot service those loans, and pay interest on them, and that those assets will not in the end prove to be satisfactory assets.

I think this is a period in which a lot of care has to be taken to create conditions in which those loans can be serviced, and a good deal of progress has been made with some of those countries over this period of time. In the case of Poland, those loans have been reserved against rather heavily, and payments have not been current despite a lot of renegotiation. I think that's quite a different situation than you have in Mexico, or Brazil, or Venezuela.

You mentioned Argentina, where progress has been less evident to date, but that situation is still one that is, I think, susceptible to improvement and is still being worked upon. It requires a combination of fundamentally strong policies in the borrowing countries—to get their own house in order—and some spreading out or extension of the indebtedness so that it can be put in shape and serviced over a longer period of time.

Senator D'AMATO. Do you think that banks should be allowed to carry these kinds of loans, weak loans at full value? Isn't that unfair to the investors who must make investment decisions on that reported information?

Mr. VOLCKER. That depends upon which country you're talking about, which loans you're talking about. Yes, I do think that it is reasonable to carry the loans of Mexico, for instance, where there's been remarkable progress in getting their internal economy and their external balance of payments in better shape, where those loans are being fully serviced and with full disclosure of what the exposure of particular banks is.

Senator D'AMATO. I am concerned that it's only been recently that the banks have been directed to increase their capital bases. Banks are undercapitalized tremendously. We waited until the horse was out and was running down the track before taking action. Now the banking system is quite weak.

Mr. VOLCKER. I don't think that's quite fair either, Senator. We have been working to encourage banks to improve their capital positions for some years.

The capital position uniformly, I think of the large multinational banks, has improved over the past 3 years or so. We introduced guidelines earlier to encourage that process and we are in the process of encouraging still further increases in capital ratios. I think that is a problem that needs to be worked on. It will continue to be worked upon. We want to see that process move as fast as it reasonably can.

Senator D'AMATO. Are banks undercapitalized?

Mr. VOLCKER. That's a matter of judgment. From my point of view, I thought during the 1970's bank capital ratios had gotten too low, which is why we have been encouraging them to increase.

Senator D'AMATO. My time has elapsed but I'd just like to ask one further thing, if I might, Mr. Chairman.

What effect, if any, has the tremendous amounts of bad foreign loans had on interest rates? What is the premium that investors are demanding?

Mr. VOLCKER. I don't think it is the fundamental cause of high interest rates. I think we have seen at some particular points in time—we saw in 1982 for a while, we saw it during the spring for a while—bank interest rates that are somewhat higher relative to

Treasury interest rates. But it's a relatively small difference in the context of the overall level of interest rates.

Senator D'AMATO. Is that 1 point?

Mr. VOLCKER. It may have been a half to 1 point higher than normal at times, in terms of bank interest rates, bank CD rates, bank borrowing rates relative to Treasury bill rates which, in turn, may influence the prime rate. But you're talking about, let's say, ½ to 1 full point, at times, in the context of the overall level of interest rates.

As you know the prime rate is 13 percent. Treasury bill rates are currently about 10¼ percent. If anything, the Treasury bill rates were probably influenced to be lower than they otherwise would have been in that situation, so I don't think it's a basic explanation for the level of interest rates.

Senator JEPSEN. Do I understand you to say that the risk premiums associated with the Continental problem do affect the interest rates some?

Mr. VOLCKER. You say the Continental problem. I would say a complex of problems and concerns at times have been reflected in somewhat higher rates on bank deposits relative to other rates than has been typical of other periods.

Senator JEPSEN. How long would you expect this effect to remain in interest rates?

Mr. VOLCKER. I think it's less now than it was a couple of months ago.

Senator JEPSEN. You think it's diminishing?

Mr. VOLCKER. It's diminishing at the moment.

Senator JEPSEN. The vice chairman, my good friend Congressman Hamilton.

Representative HAMILTON. Mr. Chairman, I was late getting here and I apologize to the chairman for that.

We will go to Congressman Scheuer and then I'll go after him, or when my turn comes up. Congressman Scheuer, please proceed.

Representative SCHEUER. Thank you very much, Mr. Vice Chairman.

Mr. Volcker, there have been rumors floating about this town that the President intends to make a flat statement saying that there will be no tax increase whatsoever of any size, shape, or description in calendar 1985 and, indeed, there's a plank to that effect that's been prepared for the Republican platform.

If such a statement is made, such a plank is included in the Republican platform, what effect do you think this would have in terms of confidence in our ability to cope with inflation and high interest rates? First, I would say, on our financial markets here and, second, perhaps even more important, on our allies, governments abroad, who urgently see the United States getting a handle on its deficits of which they see tax increase as an indispensable component part along with some spending reductions, all of which they consider an indispensable precondition to establishing economic prosperity around the world.

They are very concerned around the world with how we intend to cope with our deficits and the degree of courage, and forthrightness, and professionalism that a future President will use, of whatever

party, in applying a mix of spending reductions and revenue enhancements as it's been euphemistically called.

Given a flat statement by the President that there will be no tax increases whatsoever next year, what effect will this have on our financial markets at home and on governments all around the world?

Mr. VOLCKER. Let me approach that question, if I may, in a somewhat less political context. I think that the deficit problem, the size of these deficits that we have today and the size of the prospective deficits, against the background of an economy that's now operating at a much higher level and is generating many private-credit demands, is a very large threat to the stability and progress of the economy, and that it must be dealt with as a matter of first priority. I think measures to deal with that deficit would be important in the confidence of markets here and elsewhere, and the confidence of more than just financial markets.

How you go about dealing with that deficit is obviously a decision which is in the midst—and properly so—of the political process. I have said for years, and I am saying nothing different now, that in terms of dealing with the deficit from a strictly economic point of view—and you gentlemen have to put it in the context of more than the strictly economic point of view—the more that can be done in terms of reducing expenditures the better.

To the extent that that deficit gap cannot be closed sufficiently by reducing expenditures, then I think you have to look at the revenue side of the budget. You have to do both of those things just as soon as you can.

Representative SCHEUER. I agree with that. We have to do them in concert. Do you see any remote likelihood that we're going to have something on the order of magnitude of $200,000 worth of reductions possible on the spending side that would make at least some kind of moderate tax increase unnecessary?

Mr. VOLCKER. I would guess you're not going to see $200 billion of expenditure cuts. But neither do you have a $200 billion job. The deficit this year is probably in the neighborhood of $175 billion. It could be higher, it could be perhaps a little lower next year, depending partly on the growth of the economy.

You don't have to eliminate that all in one fell swoop. As you begin to eliminate it, taking very appreciable steps to eliminating it, I do think it would have favorable effects on markets which would help to get interest rates down.

You'll begin getting secondary effects, moving in the direction we'd all like to see it move. But you don't need $200 billion, which would strike me as outside the range of political, economic, or social feasibility.

Representative SCHEUER. You said 175?

Mr. VOLCKER. You don't even need to do that much immediately. It is important to take a big bite as promptly as you can. I think you're going to have to sit down and figure out just how to do that. I would do as much as you can on the spending side, but to the extent you can't do the requisite amount that way quickly enough, then I think you have to turn to the revenue side.

Representative SCHEUER. Just to sort of sum up issuing partisan politics totally, you can see no negative implications that would be

drawn from the financial community in this country or economic ministers, treasury ministers, chiefs of state around the world, from a flat declaration by the President that there would be no tax increases whatever in 1985?

Mr. VOLCKER. I think there would be negative implications from a feeling here or abroad that decisive efforts would not be taken to reduce the budget deficit.

You can get into the kind of questions that concern you as to whether the credibility of that effort is consistent with the approach that you describe. Opinions may differ on that, but there's no doubt in my mind that failure to attack the deficit head on after the election would be greeted negatively.

Representative SCHEUER. Thank you, Mr. Chairman.

Senator JEPSEN. I thank you. And as you say, on a partisan political basis, I think the President was asked, what's your secret plan for raising taxes. That's the rhetoric. I think he responded, I don't have a secret plan.

Now, what that gets transposed into is something else similar to the question in 1982, what's your secret plan to take away people's Social Security 10 days before the election.

It's a campaign year. It's rhetoric.

Congresswoman Holt.

Representative HOLT. Thank you, Mr. Chairman. Thank you, Mr. Volcker.

The gentleman from New York commented on the attitude of our friends and allies in Europe and around the world. I have had some problem with that in discussing the situation with a lot of the financial heads in these countries.

They want us to reduce our deficit, spend more for defense, get the interest rates down, lower the dollar value, and do all of the above.

But, this large rise in our imports has helped stimulate economic activity among some of our leading trading partners and has eased somewhat the severe adjustment process underway in Latin America. And the Europeans are claiming that the large deficit has pulled potential capital out of Europe.

What is the net effect, in your view, of these two forces on the European economy. We're keeping some of them alive with our trade deficit. Now what do they want?

Mr. VOLCKER. Obviously, they would love to have it both ways.

Representative HOLT. All of the above?

Mr. VOLCKER. And they can't always have all of the above. There's no question that the expansion of the American economy and the expansion of imports that has gone along with that has been of enormous help in facilitating these very difficult adjustments in Latin America and has provided stimulus, in various degrees, to some of our trading partners in the industrialized world.

At the same time, the level of the dollar—to some limited degree at any rate—in terms of inflationary repercussions in those countries and the level of interest rates related to the capital outflow have worked in the other direction.

It's very hard to say where that balance lies at the moment. I think, for a while, it was a clear imbalance in terms of development of the rest of the world.

I think that is more questionable now, as our economy gets more fully employed, and presumably our imports will not continue to go up at the same rate of speed.

High interest rates, in fact, some increases in interest rates recently, have remained a factor pulling capital here. It seems to me, from our own point of view, in terms of the sustainability of our own recovery, it is exceedingly important, as we've been discussing, to deal with that deficit, in order to take some of those pressures off of interest rates. That works in the direction that's in the interest of the rest of the world, too.

Representative HOLT. In considering the deficit, is it valid to take into consideration the surpluses that some of the local jurisdictions have within total Government deficit. Some say that there'll be a $60 billion surplus.

Mr. VOLCKER. There is surplus in the State and local government accounts as reflected in the National Income Accounts. I find it a bit strange myself to say that's a justification for the Federal Government to run extraordinary deficits. This seems to be a kind of reverse revenue sharing.

I would note that the major element in the surpluses of State and local government accounts happens to be the pension funds, which are accumulated, as are private pension funds, for the benefit of the employees.

Private pension funds are in the private sector. By convention, State and local government pension funds are put in the State and local government sector.

You can argue that they might just as logically be put in the private sector because they are also for the benefit of the employees.

I don't think it's an excuse for the Federal Government to run large deficits, to eat into the savings generated by those pension funds, anymore than they should be absorbing the savings in private pension funds.

There are much smaller amounts of operating surpluses in State and local governments currently. They did a lot of tax increasing and expenditure reduction during the recession, you will remember to maintain balanced budgets, as almost all of them have to do by their constitutions.

With the higher taxes and with the economy growing, some of them are generating surpluses. But the historical record has been that those surpluses don't last very long. Basically, State and local governments run balanced budgets apart from these pension funds.

Representative HOLT. Some attribute the dollars strength to an interest rate differential in favor of the United States but hasn't the interest differential moved against the dollar most recently. How much of the strength is due to our good inflation performance or the safe haven concept. What factors do you see at work?

Mr. VOLCKER. I think this is an area where I could also respond "all of the above." I think it's been a combination of influences. Certainly the political stability of the United States, to take non-economic factor, has looked attractive in recent years, with uncertainties in many areas abroad. As you know, our rapid economic recovery, the progress made against inflation, the increasing profitability of American business have all been factors in helping to attract funds to the United States.

But I don't think there's any question that rather wide differentials in interest rates compared to some of the most important other industrialized countries have been a factor. I don't think interest rates are the full explanation, but they certainly help pull the capital in this direction.

Representative HOLT. Thank you, Mr. Chairman.

Senator JEPSEN. Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman, I want to talk a little bit about the Continental Bank problem, too, as I guess some of my colleagues have done.

Is it now the policy of the Federal Reserve not to let a big bank fail?

Mr. VOLCKER. I don't know what you mean by "fail." Are you talking about failing in the technical sense of the stockholders losing or of closing the bank with the depositors losing money? I can't speak for the Federal Reserve alone here. We have a safety net apparatus that extends beyond the Federal Reserve, but the Federal Reserve's an important component in it.

In general, our approach is to try to deal with any of these situations in a small or large bank in a way that minimizes losses. And most small bank situations are dealt with in a way that does not involve any deposit loss.

If the bank is actually failing in the technical sense, typically a merger is arranged with another bank, sometimes with FDIC assistance, which enables the banking operation to continue.

In general we would look for solutions that don't interrupt the continuity of banking operations.

Representative HAMILTON. What I mean is, when a bank fails, it goes out of business. And a number of small banks have gone out of business in the last few years.

Mr. VOLCKER. Mostly by merging with another bank; in that sense, they have not gone out of business.

Representative HAMILTON. Some banks have gone out of business, though.

Mr. VOLCKER. A few. Very few.

Representative HAMILTON. That's what I'm talking about. Is it the policy of the Federal Reserve not to let a major bank go out of business.

Mr. VOLCKER. I think we would try very hard not to let that happen. There's no policy to prevent a major bank from going out of business in the sense that there's no policy against a merger in these situations.

That was one possible outcome of the Continental Illinois situation. The possibility of a merger or acquisition by another bank was actively explored.

Representative HAMILTON. Well, in this case, you couldn't work out a merger?

Mr. VOLCKER. In that case we could not work it out, yes.

Representative HAMILTON. The Government had to step in and take over the bank or at least 80 percent of its assets, as I understand it. So you made a decision, or someone made a decision, that we're not going to let a big bank—Continental in this case—fail. And you were not able to work out a merger.

Now let me go on. My understanding is that the reason you made that decision and, frankly, I don't know if it is the right decision or not, but the reason you made the decision is because if Continental went out of business, if it failed, that would have a very profound impact on confidence in the banking system.

That may be a very valid reason for saving Continental. If it is a valid reason for saving Continental, then it seems to me it's probably a valid reason for saving any other big bank in the country.

Therefore, I ask the question is the Federal Reserve going to take the position—and other banking regulators—that you're not going to permit a big bank to go out of business?

Mr. VOLCKER. We're certainly going to try our hardest. We have very powerful tools to provide a continuity of banking services to avoid that kind of shock to the system.

I think that's a basic reason why we are here.

Representative HAMILTON. I'm not critical of the decision on Continental. Frankly, I don't understand it all that well. But I'm trying to understand what kind of climate we're operating in with regard to major financial institutions.

Mr. VOLCKER. Continental Illinois has had, as we add this up, assets in excess of its liabilities. The bank is solvent in that sense, and we don't go around closing solvent banks.

I think the difference between the approach toward Continental Illinois and any other bank has been somewhat exaggerated in some people's minds. The point I'm making is that with small banks we would take the same approach.

Representative HAMILTON. The Federal Reserve is not going to step in and buy 80 percent of the assets in a bank in a small town in southern Indiana.

Mr. VOLCKER. No, but the FDIC often provides assistance to let's say, a small bank in Indiana, at least to a bank acquiring a small bank in Indiana that might be failing. That is a typical and common approach. FDIC assistance is provided to the acquiring bank.

This was an option in this case, if there were an acquiring bank ready, willing, and able to take over Continental. That did not prove to be the case.

Representative HAMILTON. Another aspect of this that bothers me, Mr. Chairman, is the role of bank regulation. I've just been reading an article in the Wall Street Journal this morning on the anatomy of the Continental Bank failure.

Let me just quote a paragraph or two from that column, if I may, to you.

"Back then Continental lending officers,"—they're speaking of a few years back—"became renowned for going anywhere, anytime to generate business. Most important, though, they seemed to be willing to do it at any price."

Then, a few paragraphs down, they quote a young lending officer of that institution, "The feeling was that there was an unlimited amount of money backing us up to lend. The point seemed to be for us to be the biggest lenders. We felt like we were the Boston Celtics of bankdom."

Now how is it that our banking regulation system doesn't catch this problem when a bank is out of control like Continental apparently was.

Mr. VOLCKER. I think these things are always easier in retrospect than prospectively. And I don't want to suggest that there are not lessons to be learned out of this and other situations as to how to do banking supervision better, but it is much easier to make those comments about Continental Illinois after the event than before it. This is a bank that was very highly regarded in the banking world. Indeed, the management won some kind of a prize 4 or 5 years ago for being the best managed bank in the United States.

Representative HAMILTON. Continental did?

Mr. VOLCKER. Yes.

Representative HAMILTON. When was that?

Mr. VOLCKER. About 4 or 5 years ago.

Representative HAMILTON. That's about the time of these quotes.

Mr. VOLCKER. That's right. I suppose you can reconcile the two quotes by saying that there was a lot of feeling that this aggressive lending behavior, which clearly turned out to be overly aggressive, was considered appropriate banking policy.

Representative HAMILTON. Is it your judgment that Continental is the only major institution that has lent imprudently and massively in the last few years?

Mr. VOLCKER. I think Continental Illinois, in its totality, is a unique situation, in terms of its volume of lending in some vulnerable areas.

Representative HAMILTON. We're not going to see another Continental instance soon, in your judgment?

Mr. VOLCKER. I dont think we're going to see another Continental as far as the particular dimensions of this situation. Penn Square Bank was a bank that did fail and was closed. It's a very rare occurrence for a bank of that size, a rather rare occurrence for a bank of any size, but it had become so overextended that it was impossible to raise a merger or another solution to that problem. They had, as I recall, about $2 billion of loan participations which, as it turns out, were extremely weak credits, and about half of those loan participations were with one bank, Continental Illinois. I think that is one symptom of the uniqueness of this situation.

Representative HAMILTON. The FDIC has said here in the article that they're prepared to pump in more money as may be required in the Continental situation. As I read that, the sky's the limit; no restriction whatever.

Suppose things go sour there, even under the excellent management that the Government will give the bank, as we all know that it will. Suppose things go sour then, my concern is, what's going to be the impact on the taxpayer. Are you going to be coming up here in that instance, then, and asking us for appropriations?

Mr. VOLCKER. No, I can't visualize that circumstance, Congressman Hamilton. The FDIC has excellent management in that bank, and it is private management. I think those gentlemen weil understand what needs to be done. There is a very large challenge. The bank is going to end up smaller in size than it has been. It will not be the most aggressive lender among the large banks. Based upon very close examination of that bank, I am confident that large fur-

ther commitments from the FDIC will not be necessary, although as the FDIC has said, they are prepared to provide it if that judgment is wrong. But I don't see that large additional amounts will be necessary, and what amounts are necessary are well within the capacity of the FDIC fund, which is built up through insurance payments by the banks itself.

Representative HAMILTON. Will it be necessary to increase those assessments?

Mr. VOLCKER. They have refunded part of the assessments for many years and are currently giving either smaller refunds, or—I don't remember exactly—maybe no refund at all. The charge for banks is bigger now than it was some years ago, in order to assure that that fund is of adequate size.

Representative HAMILTON. My time is up, and I will just conclude with this question: What is the lesson of Continental for us with regard to deregulation? We're in a period of deregulation of financial institutions.

The question is, Was the deregulation a factor in Continental's problems, and is the lesson of Continental that we've got to regulate these banks more rather than less?

Mr. VOLCKER. I don't think the recent steps toward deregulation going back 2 or 3 years were a factor in this situation, but I myself think there are two kinds of lessons from this situation. Looking at the bank itself and banking behavior—bank lending behavior, bank funding behavior, bank capital positions, as Senator D'Amato mentioned—I think the lesson clearly is that banks cannot afford to forget the crucial importance of maintaining confidence and maintaining conservative behavior patterns that are suitable to an institution that rests, in the last analysis, on public confidence.

That goes to very traditional, continuing questions—eternal verities, if you will—about how to run a bank. When one talks about deregulation, in the sense of legislation before the Senate, for instance, in terms of whether bank holding companies might reasonably be permitted a wider scope of activities beyond those traditionally associated with a bank itself, I don't think the implications from Continental are any different from what I, at least, have felt for some time. There is a range of activities, it seems to me, suitable for bank holding companies that does not entail undue risk and that provides, in fact, some possibility for dispersing risk—perfectly reasonable and straightforward activities for a bank holding company to undertake. That process should continue, in my view. There may be activities that present undue risk, present real questions of safety and soundness, but I've been opposed to those activities right along, and it reinforces my continued concern about those particular types of activities.

Representative HAMILTON. Thank you, Mr. Chairman.

Senator JEPSEN. To clear the record, in the Continental Illinois situation, where does this money come from, when you say the Government bails them out? Then I've heard folks say "Well, we've got a system set up where all banks contribute, and they've been prepared for these type of things."

Where does this money come from? Is this taxpayer dollars?

Mr. VOLCKER. The FDIC money comes directly out of its insurance fund which, as I indicated, has been built up over the years—

to an amount of about $16 billion currently—by contributions from the banks themselves. There's an assessment on the banks each year. The Federal Reserve is also involved in lending to Continental to meet liquidity needs. Certain of those loans will be transferred for a period of time to the FDIC. That money, in effect, substitutes in our portfolio for government securities that we would otherwise hold, and we do this as part of our normal responsibilities for providing liquidity in time of need to the banking system.

Of course, the Federal Reserve is funded quite independently of the budget and the Government at large.

Senator JEPSEN. Did the FDIC raise insurance rates this year to make sure they'd have adequate resources to cover losses?

Mr. VOLCKER. I don't think they did this year but, as I recall, they provided fewer refunds last year or the year before—or it may have been this year—and have continued that process.

Senator JEPSEN. Well, the insurance rates that have been worked out over the years, are they adequate? This money that's been withheld, is that fully adequate to pay this? We had a bank in Iowa within the last month that closed late one afternoon and opened up the next morning. The FDIC, in the meantime, when it opened up the next day had asssumed or picked up some number of millions of dollars of bad loans.

Mr. VOLCKER. I believe the FDIC fund is fully adequate to meet all the contingencies that one might imagine.

Senator JEPSEN. Do you have any idea how much is in that fund?

Mr. VOLCKER. It is something on the order of $16 billion currently.

Senator JEPSEN. $16 billion. So that fund then does not include tax dollars as such?

Mr. VOLCKER. No.

Senator JEPSEN. In your testimony to the Senate Banking Committee last week, you referred to supervisory guidelines aimed at smoother, more lenient solutions to many of the problem credits of agricultural banks. I think it's very important to maintain flexible solutions and insure the maintenance of our agricultural resources in these times, and they are very tough times, very critical, crucial times for both the producers, the farmers and many of the rural banks.

Could you elaborate on the measures that you would suggest that provide more flexibility for them?

Mr. VOLCKER. The measure that I referred to in my testimony is certainly limited, and our authorities and powers are appropriately limited in this area. What we have not wanted to do is, through the supervisory process, through the examination process, inadvertently or otherwise, to put pressure on banks and through banks on their borrowers, let's say, for foreclosure in instances where loans payments are not being maintained but the basic creditworthiness of the loan is still good. We have not only instructed our examiners, but also undertaken procedual steps to make sure their work is reviewed in a manner that avoids inadvertently adding to pressures on otherwise creditworthy borrowers.

I think there is an analogy to the international situation that Senator D'Amato mentioned, where the problems are somewhat similar. You have, in part, a set of external events—high interest

rates, pressures on farm income--that have impaired the ability of some farmers, particularly the heavily indebted farmers—which are not the majority of farmers—to make repayments and have placed them in a financial squeeze. Some of them still have ample, basic asset value to make those loans ultimately good, in those cases, we don't think that it's up to us as supervisors, us as examiners, to overrule a bank's judgment, when the bank thinks it's wise to exercise forebearance.

Senator JEPSEN. People say, what would help the business, the rural community, the agricultural community, and I say, get exports up and interest rates down. In the conversations we have repeatedly with regard to some of the problems in our trade area in this country, including those who propose forms of protectionism and others, we talk continually about the dollar strength, the value of the dollar overseas.

Has the interest differential moved against the dollar more recently? How do you evaluate, or would you describe, please, for the record, why the value of the dollar, the dollar's strength is continuing, in fact, in the last few weeks has increased? Is that due to our good inflation performance, the safe haven concept, or what are the factors at work on the value of the dollar?

Mr. VOLCKER. I don't want to try to explain every fluctuation in the dollar over a period of several weeks. I think it is safe to say that the dollar has been influenced by a variety of developments over the past 6 months or a year, including—if one looks at a period of several months—some increases in U.S. interest rates relative to most of our trading partners. Certainly, the good inflation news—the expansion of the economy, high corporate profits—has contributed to an environment in which the United States has been a very attractive place for people in foreign countries to put their savings. As they put their savings in the United States, it's put upward pressure on the dollar, even though the trade deficit is getting larger and larger, and, in my judgment, is unsustainably large.

Senator JEPSEN. We need to achieve steady growth in ways that relieve pressures on the vulnerable sectors of our economy—farming, housing. How do we relieve this pressure and avoid protectionism?

Mr. VOLCKER. I can tell you the method that seems to me to be the only feasible, satisfactory one, and that meets all our goals and the goals that you're talking about, the goals of foreign countries; that is to reduce our budget deficit just as forcibly and as fast as we can. That will be reflected in the interest rates. It will be reflected favorably, I think, in developments abroad and will improve our export markets and greatly enhance the prospects for maintaining sustainable growth.

I don't know any answer other than that one. Without attacking that fundamental, I think anything else we do is icing without the cake.

Senator JEPSEN. Finally, Chairman Volcker, I have three questions which relate to a fourth one, and I'd like for the record to get as direct an answer as possible on the current stance of monetary policy.

First of all, are you pursuing a bank reserve target in your monetary policy?

Mr. VOLCKER. In general, our policy goals are set out in terms of desired growth in the monetary aggregates. We will judge that in the light of developments with respect to the economy and prices, but the basic targets are set out in terms of those aggregates. In our operational positions, yes, we work by affecting the degree of pressure on bank reserve positions, and those pressures are affected most directly, I think, in the level of borrowings at the discount window.

Senator JEPSEN. Are you pursuing an interest rate target?

Mr. VOLCKER. No.

Senator JEPSEN. What was decided at the last Federal Open Market Committee?

Mr. VOLCKER. I think I said all about policy that I can properly say in my prepared statement.

Senator JEPSEN. Is your policy looser or tighter?

Mr. VOLCKER. I have indicated in my prepared statement what decisions we made with respect to the monetary targets. We have not changed those for this year and, in that sense, I don't think you can say policy is either tighter or looser in terms of the pressures that we have placed upon bank reserve positions.

I said that since the spring or early spring to date we haven't changed them. That is an operational decision that's always subject to change.

Senator JEPSEN. Is this correct? Would you consider about a 3 percent growth rate in March, about a zero growth rate in April, to be a loose policy?

Mr. VOLCKER. No. But I think those monthly fluctuations tell you nothing in terms of indicating what policy is over a period of time. You get fluctuations from month-to-month which are of no significance.

You have to look at them over a somewhat longer timeframe. We had low growth, relatively low growth, in March. We had about zero growth, as I recall, in April. That was followed by 2 months of quite sizeable growth, and in early July there was very little change.

Senator JEPSEN. On the basis of what you said, if the Federal Reserve maintains the money supply within the targets, if inflation remains under control, and if the banking crisis abates, would you expect declines in interest rates from the current levels and when?

Mr. VOLCKER. That depends very much upon what happens to economic activity and what happens over a longer period of time to the budget.

We have had a period, as I indicated earlier, since the spring, when interest rates have tended to rise until quite recently. The Federal Reserve has made no change in its operational approach, no change in its basic policy. We have had a rapid expansion of private credit on top of a very large budget deficit.

I don't think it is terribly surprising, against a background of rapidly rising economic activity, that that was reflected in interest rate pressures. If you project the same thing for the next 6 months, it wouldn't be surprising to see interest rate pressures.

If you saw an appreciably slower rate of growth in economic activity, a diminution of private credit demands, you might get a different picture.

I think that all lies in the future. All we can do is see what happens.

Senator JEPSEN. The supply of money has something to do with the interest rates, doesn't it?

Mr. VOLCKER. It has something to do with interest rates in varying ways if the supply of money is excessive and leads to inflationary expectations.

You might expect, for a while, that a decided increase in money might have the effect of reducing short-term rates. But that won't last if it is inconsistent with a sustainable rate of economic growth and less inflation. It will have exactly the opposite effect under those circumstances. It all depends upon the setting in which you're operating.

Senator JEPSEN. Under our old formula, then. Senator D'Amato, I appreciate you letting me take a little extra time here.

Under the old formula, What is the inflation rate today? The formula we were using to measure inflation in 1980, under that formula, What is the rate of inflation today?

Mr. VOLCKER. You are referring, perhaps, to the change in the Consumer Price Index?

Senator JEPSEN. Yes; it was changed.

Mr. VOLCKER. There was a change made in the Consumer Price Index about 18 months ago, mainly in the treatment of housing, which has gone up more rapidly than it would have using the old definition.

As it happens, it's a kind of a fluke, if we kept the old definition, we would have seen, using the measure of the Consumer Price Index, a slower rate of inflation. That may not be the best measure of inflation in the economy as a whole, but it is a measure.

Senator JEPSEN. But the rates on the basis of the way it was measured in 1980 when it was 13½ percent or in the first 3 months of 1980, inflation was 18 percent and going up. What, under that same formula, would that inflation be today, ballpark?

Mr. VOLCKER. If you look at it over the past 12 months—and I'm going by memory—about 2½ percent.

Senator JEPSEN. About 2½ percent, that's pretty good.

Senator D'AMATO. On that line I'd trade a little bit of lower interest rates for a loosening up of the money supply. People are coming into the market and I think that this monetary policy you're pursuing in terms of regulating, the monetary aggregates is cut too fine. Quite frankly it is too hard to fathom Fed policy. First, we must watch M1, then it is downgraded in importance. It is no wonder that the market reacts to most any rumor on Fed policy.

Mr. VOLCKER. I didn't say don't pay any attention to it, I say observe it intelligently.

Senator D'AMATO. The market shudders after every Fed Open Market Committee meeting. They say: Oh my God, what are they going to do now.

Concerning budget deficits, the fact of the matter is, yes, we've got to hold the line on all spending. But I haven't heard you ever come out and say let's hold the line on spending across the board.

You can't have it two ways. Let's hold the line across the board. You should give us specifics, not general statements.

And of course, I say, on the political side to my good friend the Congressman, the answer isn't just tax hikes. If we're just going to raise taxes and continue the spending, then we are just spinning our wheels. Tax and tax, and spend and spend. Is that the Congressman's answer to deficits?

At some point in time we've got to be able to say, yes, there are good programs. There are necessary programs and we understand it. But if we want this economic system to survive, then all of us—a shared sacrifice across the board, excluding none, hold the line.

But nobody talks abut entitlement programs. You can't even talk about Social Security, my God. We just passed a program that's going to cost $5 million more. And we're going to write home about it. This was not fiscal responsibility.

Let me tell you the politics of the day. Political expediency. Let's rush to it, boys, we want to make sure that somebody else doesn't promise somebody something special. Spend, spend, and more spending and talk about deficits.

We understand that. I don't know if it's ever going to change. There's only one person who was running for office, who ever said anything intelligent on the whole issue of deficits. That was Fritz Hollings. He said, hold the line across the board.

Of course he got absolutely no place. But having said that I hear your approach on this. Fine. I agree we should cut the deficit. But you offer no specifics. You are just like other politicians.

I still want to get back to Continental Illinois because, let me tell you something, it was 2 years ago when Penn Square went bust and Continental Illinois' president said publicly, we're going to continue to pursue an aggressive lending posture.

Let me say this to you. I agree with you when you say that you can't have a bank examiner questioning the day-to-day decisions made—the business decisions made—day in and day out.

But I do think—and I want your comment on this—that if we had some public disclosure that the marketplace would better be able to react to problems. Investors ought to know the general composition of a bank's loan portfolio.

Don't you think that public disclosure would go a long way toward protecting investors?

Mr. VOLCKER. There happens to be public disclosure of foreign loan positions.

Senator D'AMATO. But investor disclosure does not occur until after loans are under water. Investors do not know until after they have been burned.

Let's let the record show—not one of those countries in trouble has paid a penny back on its debt. They're paying interest. Isn't that correct?

Mr. VOLCKER. No; that's not correct.

Senator D'AMATO. Bolivia, Poland, Peru, Argentina, have they paid any money back on their principle?

Mr. VOLCKER. Those countries, on balance, certainly have not paid back money on the principle. But there have been very limited amounts paid by some other countries. You made a very sweeping statement; it isn't true for all countries.

Senator D'AMATO. Let's say the vast majority of them are not paying anything toward the accumulated debt, but they're paying interest out of money from new loans.

Mr. VOLCKER. That is generally true. But you cannot expect a country that's accumulated a very large debt, has been dependent on and supported by banks and governments and rising levels of debt, to turn around very promptly and repay that debt in its totality, or even a significant fraction of it in a short period of time.

What you can hope and expect and work toward is a situation in which that debt can be serviced in an orderly way, in which new loans can be raised in a voluntary way in the market and old ones paid off as they come due.

The total of debt may not be declining; the total of debt in those countries hasn't declined for many, many years.

Senator D'AMATO. That's exactly the problem.

Mr. VOLCKER. But the total debt of most business corporations does not decline. The deficit of the Federal Government is certainly not declining.

Senator D'AMATO. But businesses have an ability to repay loans. If they do not, then they go bankrupt and investors are informed of this.

Mr. VOLCKER. I'm sorry to say that there's no likelihood or expectation that the U.S. Government is going to be reducing its debt in any foreseeable time; it's rising a lot faster than the debt of those countries at the moment.

Senator D'AMATO. Mr. Volcker, if I had to take your statements verbatim, then you would be saying that the U.S. Government is less creditworthy than these Third World nations that are in trouble.

Mr. VOLCKER. I don't believe that, but I don't think we have much likelihood of paying off our debt. Unfortunately what we have is a creditworthy Government, I am talking about the United States.

Senator D'AMATO. What about many of the Third World countries?

Mr. VOLCKER. They are in different positions in different countries. Some of them are working very hard to improve their creditworthiness, with some success.

Senator D'AMATO. Let me say something on the positive side. I applaud the resolution efforts to increase the capital requirements of the Nation's banks. I hope we can move to improved disclosure.

I think if we had public disclosure in a much broader sense than we have now, that investors would be better protected.

I don't think there's any doubt that the marketplace is worried. Yes, we can work our way out of it but I think the regulators have done a terrible job over the years allowing the situation to get progressively worse.

Mr. VOLCKER. Let me say I think they're limited in public disclosure. The fact that banks were making a lot of loans to these countries is not exactly a hidden fact.

Senator D'AMATO. They were never getting any funds paid back. Principal was never repaid.

Mr. VOLCKER. But this was generally known. We published the figures. Several years ago it was considered a prime area for bank-

ing profits and that was generally known and nothing was happening.

Senator D'AMATO. They really weren't profits. I think the regulators should have said something. If a bank says it has profits on loans that earn interest from making new loans, then the market is being fooled. Now the loans have become so large that we cannot force the banks to write them off all at once. I think that the recent disclosure absolutely reeks with fraud.

Mr. VOLCKER. You're making the assumption the loans are bad.

Senator D'AMATO. We can go through it over and over again and you can tell me that there have been several countries that have made remarkable progress, like Mexico. There may be some others who have got some oil, et cetera, and you can hope for repayment.

I'm going to suggest to you that the vast bulk of those loans made in Central and South America and other places are never going to be repaid. Not during your lifetime or my lifetime.

So let's be honest. I think the American public knows it. Why we're not saying that is beyond me.

Banks are in such a weak position. Now we are going to reward them for doing a lousy job by giving them the ability to sell commercial paper and mutual funds.

My banks know what I feel on this situation. I feel very strongly that we don't reward them for having done a poor job. They should not expend capital on new businesses.

Mr. VOLCKER. I would only say we obviously have some basic disagreements. [Laughter.]

Those issues of banking powers should be approached on their own merits, not as a matter of reward or punishment.

Senator D'AMATO. What's your feeling on interstate banking? The banking bill would penalize Illinois by allowing for protectionist regional compacts. The bill on the Senate Calendar would allow foreign banks to enter the U.S. market but not New York banks. What is your feeling on regional banking?

Maybe we can conclude on some area of agreement.

Mr. VOLCKER. If you're referring to these regional compacts——

Senator D'AMATO. That excludes New York and California.

Mr. VOLCKER. There are certain discriminatory aspects to them, potentially. I do not think that is a good, long range policy toward the structure of banking.

Senator D'AMATO. I knew we could find something to agree on.

Senator JEPSEN. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Mr. Volcker the other day the Treasury Secretary Regan commented that with very low inflation rates an very high rates of growth now being experienced in the second quarter of this calendar year that we're entering into a new era of prosperity, so to speak, combined with price stability in American economic life. Yet, your Federal Open Market Committee is projected a falling rate of growth and rising interest rates and no further decline of unemployment in the rest of this year or calendar 1985.

Now, is it a fair assumption or a fair speculation to say that the Federal Open Market Committee does not quite go along with the Treasury Secretary Regan and doesn't believe we've entered such a new era of sustained growth or price stability and rather the econo-

my remains very vulnerable to a revival of inflation that might take us to 6 or 7 percent next year.

Mr. VOLCKER. Let me speak for myself rather than the committee. There are shadings of views, and I don't want to speak for the whole committee.

Let me just describe my own views. These views are not new. You will find them in my testimony 18 months ago, before this committee and before the Banking Committee. Essentially, I feel that we have a good opportunity—I won't speak in terms of new eras; that may have some connotations that are good or bad—a good opportunity for putting the economy on a sustainable path of growth in a context of much more stability than we've seen for more than a decade.

It's an opportunity that comes along rarely. We ought to seize it. A lot of what is going on is consistent with that view, more productivity, improvement on prices—18 months into recovery with prices behaving well.

Do I think that that is a sure thing? Do I think that we will accomplish that without some basic policy adjustments? No, I do not. I think the risks and the vulnerabilities are obvious, and I talked about them in my statement, I think the single most important step that is necessary at this stage, to capitalize on that potential, is to deal with the budgetary deficit, which has quite a different character when the economy is approaching more fully employed levels, when the private economy is moving along very rapidly and generating a lot of credit demands, than it did at the bottom of the recession.

To convert the potential into reality I think there is a lot to be done, but I do think that we have a very good opportunity here, if we only seize it.

Representative SCHEUER. The official forecast of the Federal Open Market Committee for 1985, the so-called central tendency, calls for a slower rate of growth, a higher rate of inflation than for 1984. Isn't this in marked contrast to Treasury Secretary Regan?

Mr. VOLCKER. I don't know. He can speak for himself. Their committee forecast on growth reflects a feeling that the growth rate at some point has to settle down to a sustainable, long-range rate that fits in with the growth in the labor force and the growth in productivity. I think, broadly, that forecast is consistent with that and shouldn't be viewed negatively at all.

It's perfectly consistent with the view that the economy settles into a sustainable rate of growth. As far as prices are concerned, there is concern within the committee and elsewhere, obviously, that as the expansion continues and as unemployment does go down—not nearly as rapidly as it has been going down but on the declining side—as capacity is more fully utilized, as growth picks up abroad, you run increasingly into the danger of at least cyclical increases in the rate of inflation.

I don't think that inflation forecast is inconsistent with a trend toward more stability, although, frankly, I wouldn't like to see that rate of inflation.

I personally may be a trifle more optimistic on the inflation side than the committee's forecast as a whole suggested, but I certainly

recognize that it is a danger and we have to be alert to it. That remains one of our Achilles' heels.

Representative SCHEUER. Thank you very much, Mr. Chairman.

Senator JEPSEN. Congressman Hamilton.

Representative HAMILTON. Thank you, Mr. Chairman.

You said, Chairman Volcker, a moment ago that we had to get the deficits down as quickly and forcefully as possible. I think all of us, of course, would agree with that. We now have a pretty good idea of what's going to happen in 1984 on the fiscal side. We've got a deficit reduction package in place. There may be some further modest decrease in spending on the defense side, but that's still to be worked out.

In any event, it's not going to be a huge sum. If I understand the deficit reduction package correctly, the impact in the near term is not all that great when you put it all together. You put the tax increases in here, you get some spending cuts there. But they're delayed and you have increased interest rates and you net out a relatively small amount of money. I don't know just what it is that will in fact be achieved on the deficit reduction side.

So, that gives you an idea of where we are in 1984 and I think you would agree that the highest order of business for the new President—whether Reagan's reelected or the new President, as the case may be in 1985—and for the new Congress will be to get that deficit down. But it's going to take us some time to do it.

So, you're well into 1985 than before you get any kind, under the best of circumstances, of substantial reduction in the deficit, it seems to me. Now, what does that do for us? Where are we, given that fact? We are not going to move quickly and forcefully to get that deficit down, assuming that we get everything done we hope we're going to get done in 1984. What does that mean?

Mr. VOLCKER. It leaves you exposed to more risks and strains that I would like to see. The ideal time for having done this was 6 months ago not 6 months from now. We've got to live with those decisions. What we find, with the economy expanding as rapidly as it has expanded and generating as many credit demands as it has demanded, is that that is entirely good news in one direction, but it has been reflected in additional pressures on the money market and additional risks and vulnerabilities in other directions.

Representative HAMILTON. When you say more risks and strains, specifically what do you mean when you say that?

Mr. VOLCKER. I'm thinking, in considerable part, of those arising out of the interest rate picture itself. That has a number of dimensions. It works entirely against the direction of easing the adjustment problems of the developing countries. I think, quantitatively, that is the most obvious, largest impact. It works against relieving the pressures on the agricultural sector that Senator Jepsen was talking about.

It leads into renewed strains on the thrift institutions that have been under pressure, as you know, for several years. Before the industry as a whole returns to break even or small profits, with the interest rates up now, they may begin moving in the other direction.

It tends to cause appreciation of the dollar against a background of a large, widening trade deficit, which has to be dealt with at

some point. All of these coalesce into some sense of financial strain and pressure and some risks for orderly economic growth.

Representative HAMILTON. Let me pick up one of those implications that you talked about. That's the implications with regard to developing countries.

There have been a number of suggestions lately that with regard to the debt problem, the international debt problem, that we need to politicize the problem more, that we're still dealing with it too much as an economic and financial problem and not sufficiently as a political problem.

How do you respond to that. Is that your sense of it? Are you satisfied with the way we are now dealing with that problem?

Mr. VOLCKER. It's not my sense of it, given the connotations that politicizing the problem raises in my mind. I don't know quite what it raises in your mind.

I think lack of these situations, while they have some common characteristics, is individual in causes and remedies, country by country. I think all of them require severe adjustment measures in the borrowing countries, but the precise nature of those measures has to vary from country to country.

They have varying levels of indebtedness, and they are susceptible to different kinds of restructuring. I think all of those things have to be approached individually, if you mean, by politicizing the problem, some "across-the-board solution."

I frankly haven't seen any across-the-board solution that doesn't in the last analysis, rest upon large amounts of public money which I doubt is forthcoming. They all imply a certain amount of uniformity in treatment, as a matter of equity, as a matter of politics, I suppose, that gives rise to greater needs rather than lesser needs in terms of publi money. I don't see any public money available in much volume to start with, so it seems to me to raise unrealistic hopes and expectations, and in the end, to undermine the solution rather than advance it.

Representative HAMILTON. Are you in favor of some kind of a scheme whereby the increases that most private forecasters are now projecting for interest rates would not be passed on to the debtor countries?

Mr. VOLCKER. Let me put it this way: I certainly see nothing the matter with an arrangement negotiated between lender and borrower to deal with that kind of situation, if they think it's useful to do so. There are lots of precedents, as you know, in the domestic market, particularly in the mortgage market, to deal with that kind of situation and at least moderate or alleviate the effects on cash flow or changes in interest rates.

I would not discourage that approach internationally, if there is an interest by both parties.

Representative HAMILTON. Are you taking steps to encourage banks to take actions along those lines?

Mr. VOLCKER. I have only taken the step of saying what I've said here.

Representative HAMILTON. Nothing more specific than that?

Mr. VOLCKER. It is one term of a complicated problem of restructuring and renegotiating some of these debts. I think it is important, in countries where progress is being made, that the banks and

the borrowers get together and put this debt on a basis that can be sustained over time.

Representative HAMILTON. You often cite the case of Mexico as a good example here, yet in that case the Mexican Government is asking for multiyear rescheduling on a cost of funds basis, not on the basis of the prime rate. As I understand it that gives Mexico a certain point advantage on interest payments.

Mr. VOLCKER. It depends upon what the spread is, too. You've got to look at what the base is and how the rate is paid related to that base.

Representative HAMILTON. Do you support that kind of a proposal?

Mr. VOLCKER. Without getting into the details I think that's up to the borrower and lender. I think a long-term restructuring—a medium- to long-term restructuring, let's say--of Mexican debt would be very constructive.

Representative Hamilton. I have the impression that you think in dealing with this problem that the best way to handle it is still very much on an ad hoc basis. I don't mean to prejudice it by calling it an ad hoc basis but I mean on an individual basis.

Mr. VOLCKER. I prefer to call it on a case-by-case basis.

Representative HAMILTON. Rather than have an overall scheme.

Mr. VOLCKER. I don't know an overall scheme. It might be very attractive to use an overall scheme, if I knew it worked and was financeable and had all the right results.

Representative HAMILTON. How about this IMF interest rate facility that's been talked about as a proposal for cushioning these debts. How does that strike you?

Mr. VOLCKER. It strikes me as potentially making a rather marginal contribution to the total problem. It is aimed specifically at the question you raised, of what happens if interest rates go up. It would involve more borrowing to deal with that. It doesn't eliminate the problem by any means and immediately raises the question of the adequacy of IMF funding. Of course, we've just gone through that and it's a question of whether it's productive to reraise that issue at this time. I don't consider that particular proposal an across-the-board answer to anything, but it's one of many things that could be explored.

Representative HAMILTON. How do you react to proposals like capping the interest rate, which is just now being discussed in the Venezuelan situation?

Mr. VOLCKER. I just commented on my attitude toward that. If lenders and borrowers felt this was in their mutual interest, I think it could play a part in some of this restructuring. I think it could play a part in some of this restructuring. I don't think either side, as a matter of fact, has placed much priority on that approach relative to these questions of longer term restructuring, interest rate spreads, the interest rate base. Those elements in the decision seem to loom more important, as near as I can judge, in the minds of both lenders and borrowers.

Representative HAMILTON. I know these questions are difficult, Mr. Chairman. It concerns me that with a case-by-case approach, you really do raise the risk of political instability in a lot of countries. In other words, the progress is not sufficiently great that

you're able to cap the political pressures that arise. If that happens, then your economic situation just deteriorates even further.

Mr. VOLCKER. I agree with that entirely. I agree with the importance of the political stability and the will of the borrowing countries. I don't see how you eliminate that problem by an across-the-board approach. Again, you would have to look at the particular approach, but an across-the-board approach that looks nice on a piece of paper but can't be implemented would only aggravate that problem.

Representative HAMILTON. I don't want to be put in the position to be arguing for an across-the-board approach, because I'm not sure what an across-the-board approach is.

Mr. VOLCKER. Neither are most people who ask for it.

Representative HAMILTON. On the other hand, there clearly has to be given, it seems to me, much more attention and sensitivity to the political aspect of the problems that these governments are confronted with. You cannot view these problems simply as economic and financial.

Mr. VOLCKER. I agree with that entirely. However sympathetic one can be, not only to the plight of those countries but the difficulties of making the political as well as the economic adjustments, we haven't got any wands to wave to make the problem go away, to make an easier economic adjustment, to maintain political stability. If they need a lot of financing and nobody's ready to provide it, you haven't got an answer, so you have to work within the framework of what's financeable, and I think that is the essence of the difficulty. You've got to work within all these limitations, including the fact that finance is limited.

Representative HAMILTON. Well, I guess we see the problem somewhat the same. If there is a difference, I guess my sense of it is that the banks in negotiating and rescheduling loans are not as sensitive as I would like to some of the political problems.

Mr. VOLCKER. Let me phrase it this way. This may be entirely consistent with what you're saying, but I think it is terribly important, where countries have gone through a very difficult political as well as economic adjustment and can show something of a track record—even though it's only 2 years since the crisis broke upon the world's consciousness—where countries have moved as decisively as they can, have maintained not only the prospect of more stable economic policies but also the political support that's necessary to achieve that, those countries should be able to look forward to a stabilization of their external finances.

It is in my judgment, very important that the lenders recognize the importance, to their own interests, of stabilizing that financial situation with a long-term restructuring, where appropriate, and with other terms and conditions—including, perhaps, some of the things that you've mentioned—that will, in fact, stabilize the financial situation and provide the kind of base for economic growth and political stability in those countries that's necessary.

Representative HAMILTON. Thank you, Mr. Chairman.

Senator JEPSEN. Chairman Volcker, I thank you. This has been a steady 1 hour and 45 minutes.

Today's Washington newspapers report that the Soviet Union has made a $600 million windfall purchase of American wheat and

corn. As I indicated in my opening remarks, I am pleased to see your statements last week regarding the plight of the economy in my home State of Iowa and the agricultural community of the Midwest, not only in the farm producers, but the rural businesses and banking. It has not quite moved along with the recovery as rapidly as other parts of the country. We've had a slower trail in the area of national recovery than the other parts.

Do you have any views that you would care to express for the record at this time about the eventual farm outlook and the agricultural outlook as things are unfolding?

Mr. VOLCKER. I don't want to pose as a particular expert on the agricultural outlook, Senator—and I know I sound like a broken record—but when I look at a sector of the economy like the agricultural sector, where inherited financial problems of some farmers are leading to intense financial strains, I can't think of a clearer example of the benefits and potential that would come from that early and forceful action on the budgetary side.

Let me say one other thing in that connection. Given the trade deficit, and despite the overall growth of the economy, I think, apparently, we have more protectionist pressures. That's true in other countries as well as the United States. Those tend to be directed at protecting nonagricultural sectors of the economy, manufacturing in particular, but the farmers have a larger stake than anyone else, it seems to me, in keeping those pressures contained and controlled, because they're the big exporters in the United States. They're the ones who are most vulnerable to the retaliation around the world in protectionist pressures that is endemic in this situation.

The two big threats that I see to the economy generally are the budget and protectionism. The agricultural sector is right out in the forefront of that vulnerability. Of course, both of those threats can be dealt with by intelligent public policy. Unfortunately, there's some risk of shortsighted actions.

Senator JEPSEN. The ones who are in severe problems now are part of the banking, loaning errors of the 1970's, when some evidently believed that inflation was going to continue forever and that the cash-flow, which was used as one of the basic criteria in determining eligibility for loans and consummated them for a good number of years, several hundred, was sort of set aside and the question wasn't even on the forms—"How are you going to pay it back? Are you going to pyramid these assets? Everything's going up."

Mr. VOLCKER. If you're in an inflating economy, there are a lot of bets on inflation. Some of those bets have not turned out so favorably. It's not useful to repair that situation either in the farm belt or with foreign countries, by going too far on the other side and refusing to make new loans where there are creditworthy borrowers or to exercise some forebearance where the forebearance will assist in making the loan good over a period of time. We need a balance; we don't want to rock from one side of the boat to the other.

Senator JEPSEN. Finally, the Federal Reserve has projected real economic growth of about 3 percent in 1985 in the range of 2 to 4 percent. If we're fortunate enough to have a 4 or 5 percent growth

next year and inflation remains under control, as it has been, will this induce a change in the monetary policy?

Mr. VOLCKER. I can't forecast all the other circumstances but, obviously, a somewhat faster rate of growth, with inflation under full control, would itself be a relatively happy situation.

Senator JEPSEN. In fact, that real growth, if it's above your forecast, will it induce a change in your money growth targets?

Mr. VOLCKER. I don't think real growth above the forecast by itself would. We'd have to look at all the surrounding circumstances. You present a picture where productivity is growing faster than expected, where inflationary pressures are gone, where there is enough capacity in the economy to meet that kind of growth on a sustainable basis. No one would be more pleased than we.

Senator JEPSEN. Should monetary policy be directed toward price stability and not real economic growth targets?

Mr. VOLCKER. That's a very big question. Basically, I am sympathetic to the view that monetary policy over long periods of time should be directed toward price stability, yes.

Senator JEPSEN. In other words, monetary policy shouldn't unnecessarily inhibit economic growth?

Mr. VOLCKER. Certainly, it shouldn't unnecessarily inhibit economic growth. I happen to be of the school of thought that says that keeping economic growth sustainable—and I would emphasize the word "sustainable"—is much more important than whether the economy grows by 3 or 4 percent in a particular year. Is it going to be sustained? That has a lot to do with whether we can encourage and maintain a sense of price stability.

We spent 15 years getting away from that sense of stability. I think we have already had a considerable struggle forward restoring it. We're a long distance toward restoring it, and I think it is important that we continue on that course.

Senator JEPSEN. You point out the two areas of the deficits and protectionism as being great factors, having great impact on the agricultural community, and I agree.

Do you have any recommendation for both short-term and long-term monetary policy change for the agricultural sector of our economy in this country that would bode well for them, would project more profits and a brighter future?

Mr. VOLCKER. As you well know, we can't conduct monetary policy separately for the agricultural sector or any other sector. It's got to be one monetary policy for the country. I think the best monetary policy for agriculture, as well as the country at large, would be along the lines of what we just discussed, continuing to work toward a sense of price stability. I see no reason why agriculture can't be prosperous in that environment. Among other things, I think it is absolutely fundamental to seeing a return to the level of nominal and real interest rates to the area that we're thought of as normal in this country. For those farmers that are heavily indebted, that, of course, is a crucial ingredient in a successful outcome.

Senator JEPSEN. Your knowledge of the economy—for the record, the agricultural community provides an impact somewhere in the neighborhood of 20 to 25 percent of everything that goes on in our

economy. It's the largest single most productive part of our economy. Is that an accurate statement?

Mr. VOLCKER. It's certainly highly productive and very important in the aggregate, directly and indirectly—particularly important in our trade picture.

I don't know about the 20 to 25 percent number. I haven't seen that analysis.

Senator JEPSEN. I can tell you it is the single largest, single economic segment of our economy, and I want to close by telling you, I appreciate your remarks again last week, the sensitivity to the agricultural problem. It has been somewhat of an irony with the large role agriculture plays in our economy, that when I came to the chairmanship of this committee, we found that we had very few people—in fact, we had none—with direct agricultural, either formal training or expertise, in the staff, and with the role that agriculture does play in our economy, it has been long overdue, not only in awareness, in this committee, but within the financial planners and the cabinet people. The administration generally, has brought it into focus.

You helped that last week with your remarks. I try to reinforce and encourage that at every turn of the road, and I thank you for that.

Mr. VOLCKER. I appreciate that.

I would only say that we can't deal around the edges. The fundamental problems have to be dealt with, I think using the other approaches that we've been discussing.

Senator JEPSEN. Do you have any closing statement, Mr. Chairman?

Mr. VOLCKER. I do not.

Senator JEPSEN. I thank you very much for your appearance here today and your usual candid exchange.

Thank your, sir.

The committee stands adjourned.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

THE 1984 MIDYEAR ECONOMIC OUTLOOK

THURSDAY, AUGUST 2, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-562, Dirksen Senate Office Building, Hon. Chalmers P. Wylie (member of the committee) presiding.

Present: Representatives Wylie and Scheuer.

Also present: Dan C. Roberts, executive director; Charles H. Bradford, assistant director; and William R. Buechner, Robert R. Davis, and Paul B. Manchester, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE WYLIE, PRESIDING

Representative WYLIE. The meeting of the Joint Economic Committee will please come to order.

May I welcome this very distinguished panel of economists today to participate in the midyear economic outlook hearing of the Joint Economic Committee.

We are in the midst of one of the strongest and most sustained periods of economic growth in the postwar years. For 18 straight months now we have had a continuous stream of good economic news. Setting aside our two deficit problems, our Federal deficit and our trade deficit, it is hard to find any negative economic indicators, particularly those that affect us most personally and most directly, such as unemployment and inflation.

I call your attention to the chart showing the so-called misery index to my right here, which adds together the rate of inflation as measured by the consumer price index and the unemployment rate. The misery index has been cut in half in the last 4 years, from 19.4 percent in 1980 to 10.3 percent as of June 1984.

The other chart shows our strong growth in real gross national product during the past 18 months. This is the broadest indicator of economic performance, adjusted for inflation. This measure rose at a stunning annual rate of 10.1 percent in the first quarter of 1984 and at an estimated rate of 7.5 percent in the second quarter. I would think that economic growth would flow to a more sustainable pace in the second half of 1984. After all, once you have been shot out of a cannon across the Potomac River, what can you do for an encore? Almost nothing. Next time you swim across at a more steady but sustainable pace.

[The charts referred to follow:]

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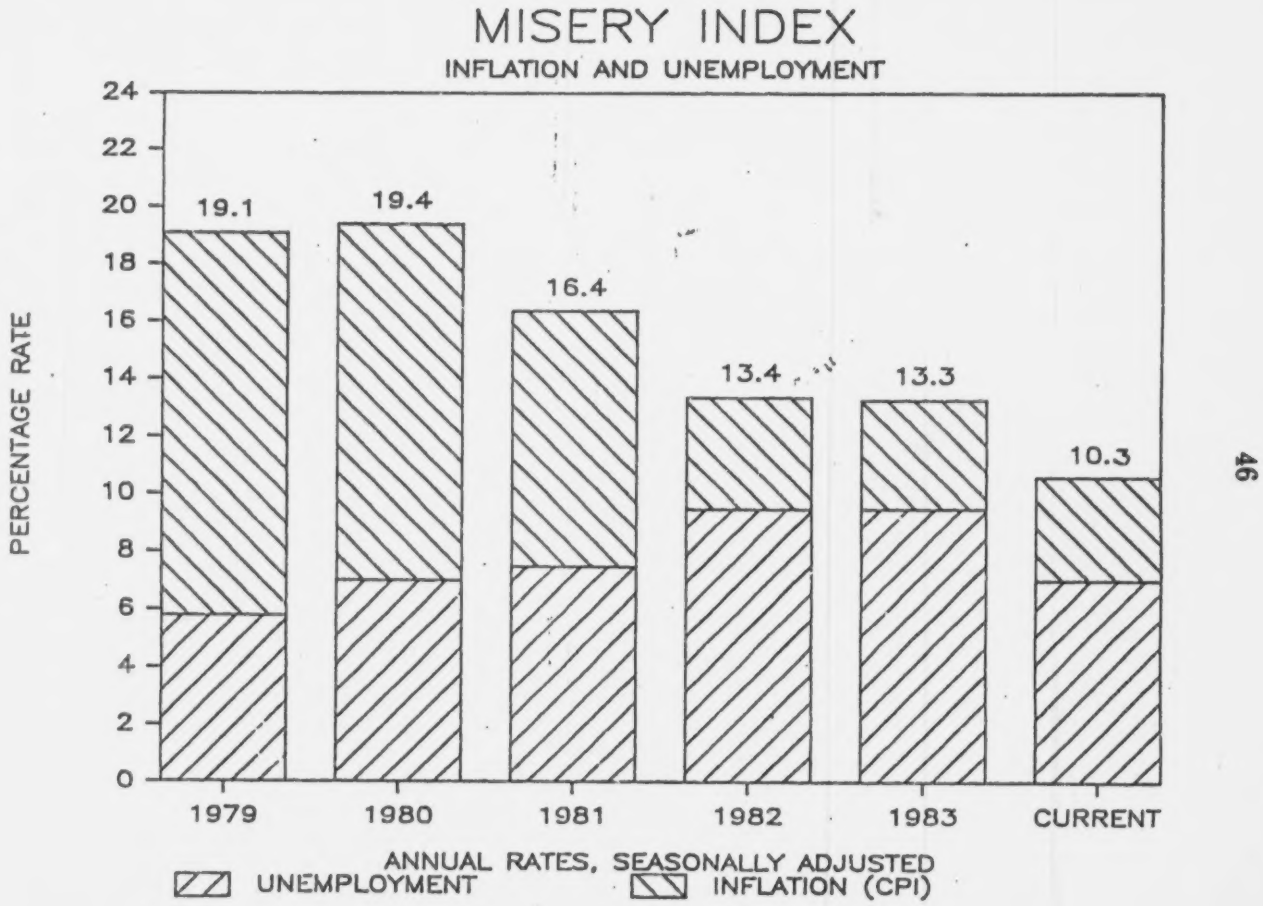
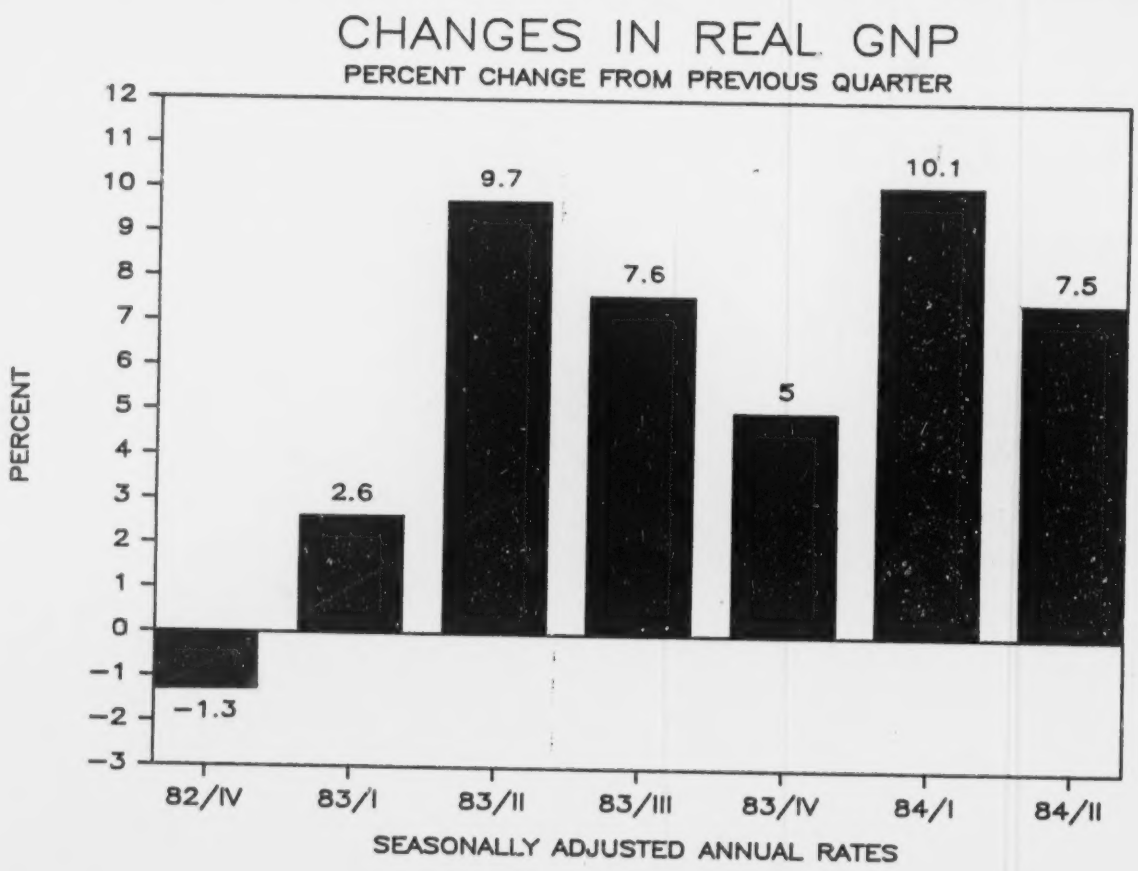

MISERY INDEX
INFLATION AND UNEMPLOYMENT
PERCENTAGE RATE
24
22
20
18
16
14
12
10
8
6
4
2
0
19.1
19.4
16.4
13.4
13.3
10.3
1979
1980
1981
1982
1983
CURRENT
ANNUAL RATES, SEASONALLY ADJUSTED
UNEMPLOYMENT
INFLATION (CPI)


CHANGES IN REAL GNP
PERCENT CHANGE FROM PREVIOUS QUARTER
PERCENT
12
11
10
9
8
7
6
5
4
3
2
1
0
−1
−2
−3
−1.3
2.6
9.7
7.6
5
10.1
7.5
82/IV
83/I
83/II
83/III
83/IV
84/I
84/II
SEASONALLY ADJUSTED ANNUAL RATES

Representative WYLIE. Gentlemen, what we want to know from you is, how long do you think this excellent economic performance will continue? What could turn it off? Can we expect strong noninflationary economic growth to continue through 1985 or beyond? You are the experts. We want to listen to you and learn from you.

Our distinguished panel this morning—and it is a very distinguished panel—is composed of Mr. Alan Greenspan, president and chairman of Townsend-Greenspan, Inc.; Mr. David Fand, professor, Wayne State University; Mr. Michael Evans, president, Evans Economics; Mr. Lawrence Chimerine, chairman Chase Econometrics; and Mr. Donald Ratajczak, Economic Forecasting Project, Georgia State University.

We do have some time constraints. So if I may ask you to kind of summarize your opening statements in about 10 minutes, then we will go to questions from our panel.

I would like at this point to call on Mr. Lawrence Chimerine, chairman of Chase Econometrics, for his opening statement.

Thank you, Mr. Chimerine.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS, BALA CYNWYD, PA

Mr. CHIMERINE. Thank you very much, Mr. Chairman. I am delighted to be here.

I have submitted a rather lengthy prepared statement which I request be included in the record. And, as you requested, I will try to summarize it very briefly this morning.

You correctly pointed out in your opening statement that the economy has done very well for the last 18 or 19 months and almost all the news has been relatively good. But I think you have to look beyond the current recovery and look at the factors beneath the surface. In my judgment the current situation is somewhat unstable, and some of these underlying factors suggest to me that there are problems ahead, with the most likely outcome that the economy will start to flatten out during 1985. In fact, while I don't think it is the most likely outcome, a new recession could develop some time during the course of 1985.

In my judgment the most significant factor which could lead to a deterioration in the economic climate is the large and rising structural deficits which still remain in place despite the downpayment package that was recently enacted. My concern is primarily that, while deficits thus far have been very stimulative and have helped support the recovery that has been underway for the last year and a half, we are now entering the period during which they are going to become counterproductive. I view a continued economic recovery and lower interest rates incompatible with the deficit outlook as it now stands. So barring any significant change in future deficits, I think either the recovery will peter out or interest rates will go significantly higher, which will eventually lead to the recovery process slowing very dramatically.

I would like to begin with a review of the deficit outlook as I see it; then focus a little on interest rates; and then tie this together in terms of what it means for the outlook during the next year or two.

By my calculations, it looks like the deficit for the current fiscal year will turn out to be about $175 billion, which is, roughly speaking, about 10 percent less than last year's deficit; also about 8 to 10 percent less than we previously had expected. These are relatively marginal differences for this point in the recovery process. Furthermore most of the decline represents a temporary shortfall in relatively noncyclical spending, particularly for national defense, farm programs, and a few other entitlement programs. It is not the result of a surge in tax revenues resulting from faster-than-expected economic growth. And, the outlook for the deficit for the next several years still remains relatively poor.

On a current services basis, with reasonable economic assumptions, I believe the deficit will rise again in fiscal 1985 and then continue to creep up in the next several years, even with the downpayment package. The actual reduction in deficits as a result of that package will be less than has been advertised, and of course, is heavily back-loaded beyond fiscal 1985; it won't do a lot to reduce the deficit in fiscal 1985.

On top of that, as the growth rate in the economy slows, the cyclical deficit will fall more slowly than it has thus far. The structural deficits will continue to rise and will have more impact, therefore, on the total; interest expense will rise very sharply, virtually negating the impact of recent spending cuts and tax increases; and of course, to the extent there is a spending catch-up, particularly as national defense accelerates, this will put further upward pressure on the deficits during the next several years.

Most significantly, this represents a dramatic change in the typical historical pattern when deficits have always fallen very sharply during early recovery years. After the 1969–70 recession, for example, the deficit fell by more than four-fifths during the first 3 years, and after the 1974–75 recession, it fell by more than half during the first 3 years of recovery. This is not taking place currently, and very significantly, for the first time in the entire postwar period, a sharp increase in the important Federal debt/GNP ratio is taking place.

In my judgment deficits have already been a key factor in the rise in interest rates we have experienced thus far this year. The increase in rates is primarily the result of a dramatic increase in the demand for credit from all sources. Total credit outstanding has risen thus far this year at a 13 percent rate, and even if you exclude the impact of mergers and leverage buyouts and so forth, it is still well above the historical average and considerably above the Federal Reserve guidelines or targets. In fact, I think we have learned that even faster-than-expected growth does not reduce the impact of structural deficits on interest rates, because while the cyclical deficit has fallen somewhat, this has been made up for by the sharp increase in private borrowing, or sharp acceleration in private borrowing, that has been needed to finance the faster-than-expected economic growth.

Therefore, on balance, total credit demands are rising more rapidly than they would have in the absence of large structural deficits, and as a result, they have become a major factor affecting financial markets, are the dominant factor, in my judgment, behind the recent increase in interest rates.

We have had a rally in the last month or so, or maybe 2 months, in the bond market. Some are concluding that this represents a reversal of the previous trend.

I don't think that is the case. In my judgment, bond prices declined too sharply previously; market fundamentals did not support that sharp run-up in long-term interest rates; it was partly, I think, in anticipation of a fast tightening by the Fed, which did not materialize.

I think this is simply a short rally in a period of rising interest rates, and in my view, we will see continued increases in rates later this year and in early 1985.

A slowing in the rate of recovery, which is now underway, will limit the upward pressure on interest rates, but will not be sufficient to turn the basic trend around, primarily because it is not the overall growth rate that now matters; it is the mix of economic growth.

We are now at the point in the cycle where inventory accumulation and capital spending are two of the major factors propelling us forward. At the same time, cash flow growth is slowing dramatically. Nonfinancial corporations over the last year, as a result, have moved from being large net savers in total to significant net borrowers because of the combination of these forces, and, of course household borrowing has accelerated because real income growth in slowing as employment growth decelerates, and in the absence of additional tax cuts. More borrowing by consumers is necessary to sustain the growth in household spending.

So total credit demands, in my judgment, will continue to rise even with slower economic growth and as a result put more upward pressure on interest rates later this year and in early 1985.

I do not believe, by the way, that the Fed has been extremely tight. Quite the contrary, I think over the last 2 years Fed policy has been extremely accommodative. They may have tightened slightly in recent months, but on balance, they have followed a very, very accommodative monetary posture for the last couple of years and have not been primarily responsible for the increase in interest rates.

Nor do I accept the view that real interest rates are already significantly above the historical average, and as a result, this will cause downward pressure on nominal interest rates. I think the correlation between interest rates and inflation has always been exaggerated, particularly in an environment without ceilings on interest rates, with financial market deregulation, with more competition for funds, and so forth. The old standards for real interest rates are thus less relevant than they have been before. Furthermore, I don't think the markets view the recent deceleration in inflation as the start of a new trend in that direction. Inflation generally does not accelerate until late in the second year or in the third year of economic recoveries, and some of the recent decline in the inflation rate reflects temporary factors such as oil and food price movements, which are likely to be reversed in the years ahead.

What does all this mean for the outlook? I think we come back to two central points. First, that simply because deficits were stimulative during the past couple of years does not mean that larger and

growing structural deficits will always be stimulative for the economy. Quite the contrary, I think ultimately they will become counterproductive.

I can remember when we began talking about this problem 2 or 3 years ago. We split the future into two parts, the short-term period and what we began to call the outyears. Well, I hate to say it. but it is almost 1985; we are approaching the outyears; we're probably already here. And in the kind of environment we are now in, where we are a year and a half or more into the recovery, the impact of deficits on the economy will begin to change, and the increase in interest rates, as well as some other factors I'll get to in a moment, reflect the first signs of that.

Second, it is important to remember that despite the fact the recovery has been faster than most people had anticipated, it primarily reflects that we are using up idle resources at a speedier rate. There is nothing to suggest that there has been any change which has improved long-term-growth prospects. We are not getting an acceleration in labor force growth; the growth in productivity has certainly not been outstanding in view of the cyclical factors and the cost cutting that is taking place; and the capital stock is not accelerating in growth.

So we are simply using up our idle resources more quickly. We are not necessarily in a brand new era that suggests that this kind of growth rate can take place forever.

The kinds of outyear deficit impacts that I was referring to a moment ago, including high and rising interest rates; an overvalued dollar, which continues to strengthen; the large trade deficits that have resulted; banking problems; a worsening of the LDC debt situation in many cases—all of these, I think, and others, represent the first signs of potential trouble ahead which will lead to a flattening out in the economy by 1985.

It is also well to remember that in addition to the fact that we are using up idle resources more quickly than expected, we are also beginning to use up a lot of that pent up demand that was created during that long period of stagnation which preceded this recovery. That tends to mean that slower growth is likely ahead even in the absence of rising interest rates, and when you add the direct and indirect effects of the increases in rates that have already occurred as well as additional ones that I think are likely, a flattening in the recovery, with potentially another recession, is likely sometime during 1985.

As of right now the economy is holding up well. I think this reflects a number of factors. First, the increases in rates thus far have been relatively small, at least based on our new standards.

Second, until about a month or two ago, they were concentrated in the long end of the market which has less impact on economic activity now than do short-term rates.

Third, until quite recently they had not spread into consumer rates.

Fourth, consumer confidence has held up extremely well.

In my judgment these factors will change, particularly as the pressures on interest rates intensify again later this year and in early 1985.

We already have a number of signs, in addition to the ones I mentioned, of a coming significant slowdown in the economy. I think the housing industry has peaked. New homes sales and single-family-home starts have come down. Inventories are rising. And based on reports we get from the field, current traffic is continuing to slow.

I think you will see a further weakening in the single-family-housing market, and by late this year or early next year, that will begin to spread into other industries.

Commodity prices are down sharply, and you will hear more about that, I'm sure, later. There are lots of reasons for it, some related to reduced speculation because of high interest rates, the effect of the strengtening dollar, and supply factors.

But based on the information we are getting, some of it also reflects at least a modest weakening in underlying demand for many of these commodities. New orders have been essentially flat, particularly for durable goods, for the past 5 or 6 months, after rising sharply during most of 1983; the dollar continues to strengthen, which will create further trade problems for us; and the stock market has been relatively weak, even with yesterday's rally for about 1 year. And if you take a broad view of the market, I think the magnitude, length, and breadth of this decline suggests to me that probably more than a technical correction is occurring here and it may be indicative of some of the problems we expect to see in the economy during the next couple of years.

In sum, I think the impacts of large and rising structural deficits, an overvalued dollar, high and rising interest rates, trade deficits, the excessive growth in debt which has been experienced in the last year or two, particularly short-term floating rate long-term debt, the increase in credit risks throughout the system—all of these factors will probably lead to at least a flattening out of the economic recovery process during 1985. And as I said earlier, depending on how much consumer confidence deteriorates, how much the Fed tightens, whether the stock market keeps going down, whether the dollar keeps strengthening further, this process could actually lead to the start of another recessionary environment during 1985.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine, Chairman and Chief Economist of Chase Econometrics. I appreciate the opportunity to testify before the Joint Economic Committee. I will focus my remarks today on the economic outlook and related policy issues.

SUMMARY

In summary, my views are as follows:

1. Despite faster-than-expected economic growth and passage of the down-payment package, Federal deficits will rise somewhat during the next several years.

2. The recent rally in the bond market does not change the basic trend of interest rates—I continue to expect significant additional increases in rates later this year and in early 1985.

3. While the near-term outlook for inflation remains favorable, recent declines in commodity prices do not indicate a new era of deflation.

4. Strong economic growth during the first half of this year has exhausted idle resources more rapidly than expected, without changing either the short or long-term outlook.

5. The recovery process is likely to flatten out during the course of 1985, with little or no increase in GNP expected during the course of the year. Furthermore, it is also possible that this slowdown will actually deteriorate into a full-fledged recession. The sluggishness expected in 1985 reflects the impact of increases in interest rates which have already occurred, as well as additional ones anticipated.

6. The Administration's forecast of more than 4 percent average real growth for the remainder of the decade appears highly optimistic, even with appropriate economic policies. This reflects the likelihood that the growth in potential output will be very modest in the years ahead because of relatively slow growth in both the labor force and productivity, and because the current degree of slack in the economy is not very substantial. Thus, average annual growth of between 3 and 3-1/2 percent appears to be the maximum that can occur between now and the end of the decade, even assuming the economy reaches full employment by the end of this period.

7. It is highly likely that current economic policies will also prevent the economy from growing rapidly during the remainder of the decade. In particular, the prospect of enormous Federal deficits will at a minimum further reduce long-term potential growth by holding down investment (and thereby available capacity and productivity growth); even worse, these large deficits are likely to cause further increases in interest rates, leading to a slowdown or another recession during the next few years.

8. Both the short and long-term outlook can be improved significantly by additional reductions in Federal deficits. It is essential that additional actions be implemented to put future deficits on a downward trend starting in fiscal 1985. Furthermore, relatively large tax increases will be necessary to supplement whatever spending cuts that can be made in order to achieve this objective.

KEY FORECAST ISSUES AND ASSUMPTIONS

Federal Deficits: It now appears that the Federal deficit for FY 1984 will be approximately $175 billion—however, despite extremely strong economic growth, this represents only a 10 percent decline from last year's record deficit and is only modestly less than previously expected. Furthermore, these differences are almost entirely due to a temporary shortfall in relatively noncyclical expenditures (national defense and farm aid, and other entitlement programs), rather than to lower expenditures for highly cyclical programs or to greater-than-forecast tax revenues. The latter reflects the fact that tax revenues are dependent primarily on current dollar output rather than real GNP—the strong growth in real output during the last several quarters has in part been offset by less-than-expected inflation.

Most significantly, the outlook for the deficit remains relatively poor, reflecting:

(a) The large and growing structural deficit remains in place for the immediate future, since the expenditure cuts and tax increases included in the down-payment package will reduce deficits by less than advertised (especially since the revenue gains from various loophole closings appear to have been significantly overstated), and are backloaded beyond fiscal 1985.

(b) As economic growth decelerates, resulting in a slower decline in the cyclical deficit, the impact of the growing structural imbalance on the overall deficit will increase. This will also be aggravated by a catchup to offset the shortfall in military and other expenditures in recent months.

(c) Upward pressure on the deficit will also result from the recent increase in interest rates, especially relative to previous deficit projections made by the Administration (which were based on the assumption of a sharp decline in interest rates during 1984). Each percentage point increase in average rates adds approximately $10 billion to the level of interest payments within two years. Furthermore, this becomes compounded as additional borrowing is required in later years to finance the previous increases in interest expense (and the resulting larger deficits).

Thus, the deficit will actually increase somewhat in fiscal 1985 and will continue to gradually rise thereafter in the absence of any additional deficit-reduction measures. In particular, even with the near $25 billion reduction in the deficit resulting from the tax increases and spending cuts in the down-payment package, the deficit in fiscal 1985 will rise to between $190 and $200 billion. And, on a current services basis, it will rise to about $225 billion by fiscal 1987. While this is an improvement from the current services deficit outlook which existed previously, the down-payment package is not sufficient to result in a year-by-year decline in expected deficits in the years ahead. This in part reflects the fact that much of the recently enacted spending cuts and tax increases have already been offset by the impact of rising interest rates. This deficit pattern represents a major departure from prior recovery periods when deficits have always fallen sharply—in particular, the Federal deficit dropped by more than four-fifths and one-half during the first three years following the 1969-70 and 1974-75 recessions, respectively. This outlook for the deficit implies that the Federal debt-to-GNP ratio will continue to rise significantly during the next several years, representing a sharp turnaround from the pattern during virtually the entire postwar period until the last several years.

Interest Rates: Despite the recent modest rally in the bond market, I still believe that the upward trend in interest rates remains in tact. Long-term interest rates had previously risen more rapidly than market fundamentals and likely Fed policy justified, producing a highly positively sloped yield curve—this has in effect been corrected in recent weeks by small increases in short-term rates and the modest decline in long rates. The uptrend in rates is due primarily to the extremely rapid growth in the demand for credit, reflecting the still high Federal deficit, and the surge in borrowing by both the business and household sectors. The turnaround in borrowing by nonfinancial businesses in total is especially dramatic—this sector has shifted from being net savers of $13 billion in 1983 to net borrowers at a $40 billion annual rate thus far in 1984. Total credit outstanding has risen at nearly a 13 percent annual rate thus far this year, well above both the Fed's current targets and the historical average.

The somewhat less-than-expected Federal deficit is not alleviating these pressures—in fact, exactly the opposite is occurring, since the increase in private borrowing that is necessary to help finance faster-than-expected economic growth is significantly greater than the decline in the cyclical deficit. Thus, total credit demands are actually rising more rapidly than they would be with more moderate growth. Furthermore, while a slowdown in economic growth, such as I continue to expect for the second half of this year, will take some pressure off credit markets, it will simply limit the magnitude of additional interest rate increases, rather than leading to a decline. In fact, historically, the biggest increases in rates have occurred when recoveries have matured and growth has slowed—this reflects the fact that, at such points in the business cycle, inventory accumulation and capital spending generally accelerate, and growth in cash flow tends to decelerate. Furthermore, slower growth in employment and gradually rising inflation generally reduce real income growth, forcing an increase in consumer borrowing to sustain the growth in household spending. These conditions have already begun to occur in the current expansion; therefore, even with 3 to 5 percent growth during the second half of this year and early 1985, the upward pressure on credit demands will continue. This will be exacerbated, in my view, by a gradual shift by the Federal Reserve to a less accommodative, though not extremely tight, posture after the election. The Fed will gradually tighten primarily in response to continued above desired rates of increase in most of the money and credit aggregates—the likelihood that debt rescheduling plans for many of the LDCs will be in place by that time will also remove a major constraint which is now in effect. Any reduction in the willingness for foreigners to not only keep holding the large amount of dollar-denominated assets that have been accumulated in recent years, but to continue to increase these holdings at a rapid rate, would exert additional upward pressure on U.S. interest rates. This could occur for several reasons:

(a) As the economic recovery overseas accelerates, domestic savings will be needed to finance it. The recovery will also generate more investment opportunities in these countries than have existed in recent years.

(b) Concerns about a falling dollar, which could potentially offset some or all of the extra return foreigners are earning on dollar assets as a result of relatively high U.S. interest rates, could reduce the willingness to hold dollar-denominated assets.

(c) Many foreigners may conclude that they have reached the limit with respect to dollar holdings because such holdings may be comprising an excessively large share of their portfolios.

Thus, the gap between the demand for credit and the availability of credit will widen further—I therefore expect interest rates to rise between 200 and 300 basis points on average by mid-1985, with the biggest increases for shorter-maturity instruments. Additional rate increases will occur even though real interest rates remain extremely high and, in fact, have increased further in response to both rising nominal rates and the recent deceleration in inflation. However, the inflation rate generally does not accelerate until after at least the first six quarters of economic recoveries, so that the markets are not assuming that the recent decline in inflation represents the start of a new long-term trend toward disinflation. This is reinforced by the fact that the recent numbers reflect weakness in food and oil prices, both of which are likely to be reversed in the years ahead (with food prices likely to begin trending upward in the very near term). Finally, historical guidelines for real interest rates have become less relevant as a result of the elimination of deposit ceilings, the availability of new financial instruments, increased competition for funds within the financial sector, the Fed's reduced emphasis on interest-rate targeting, and other changes of recent years. Thus, an imbalance between the demand for, and supply of, credit will likely cause significant upward pressure on interest rates even if those rates are already high relative to inflation.

Deflation: The recent sharp decline in commodity prices has raised concerns that Fed policy has already become excessively tight, and that this will cause a new era of deflation (rather than disinflation). However, based on data for virtually all measures of money and credit, the Fed has actually been relatively loose since the summer of 1982. Furthermore, while demand may have weakened slightly, declining commodity prices appear to be primarily due to rising interest rates (which has reduced speculative activity and is encouraging holders to cut inventories); to the increasing strength of the dollar (which typically causes a decline in prices denominated in dollars, in part by reducing export demand); and to increasing current and expected supplies, particularly for certain metals (especially those which are exported by debt-ridden LDCs), oil, and grains. Furthermore, while these declines in commodity prices will hold down inflation, they will not be sufficient to produce overall deflation since wage costs and other factors are much more critical for the rate of inflation. The relationship between commodity prices and overall inflation has, in fact, been weakened in recent years by structural changes in the economy which have reduced the importance of these commodities in both the content and prices of many finished goods. Nevertheless, I continue to remain optimistic about the inflation outlook for the near term, and also believe that a return to double-digit inflation is unlikely at any time during the remainder of the decade. Current inflation is also being held down by the increased competitiveness in the economy caused by deregulation in many industries, by the increased use of new technology, and by the widespread effects of the overvalued dollar beyond its impact of commodity prices.

Auto Negotiations: I continue to assume that a strike in the auto industry will be avoided when the current contract expires in mid-September. Furthermore, despite the emphasis of union leadership on job security, the membership will most likely push hard for, and win, a big dollar settlement in view of the leverage they have because inventories will be very low during the negotiation period; sales are still relatively strong; the industry is still protected by import quotas; and profits are extremely high. However, I believe that the likely settlement will include two parts: a relatively modest (5 to 6 percent per year) average increase in wages, including cost-of-living adjustments, and a one-time bonus or profit sharing payment. While the latter will increase the total size of the package sharply, it will not be viewed as being inflationary, or further widen wage differentials with auto workers in other countries, because it will not enter into the wage base for future increases. Should a strike occur, however, it will depress economic activity during the fourth quarter and, depending on when a settlement is

reached, cause a rebound thereafter—it is unlikely, however, to have any long-lasting effect on economic activity, especially since import quotas will prevent a sharp rise in sales of imported autos. An extension of quotas on Japanese imports for a fifth year will depend heavily on the outcome of the election. I am assuming that quotas will not be extended for another year, or if they are, the allowable level of imports will be increased somewhat.

THE OUTLOOK

Short-Term Outlook

Despite the much sharper-than-expected increase in economic activity during the last six months, many of the underlying fundamentals which will determine future economic performance have deteriorated. This reflects the following:

(a) I continue to believe that a continued sharp recovery and lower interest rates are not simultaneously compatible because of the large and growing structural deficit. These deficits were highly stimulative during the last two years, when the economy was coming out of deep recession—however, we are now entering the so-called out-years when large and rising structural deficits are becoming counterproductive by creating enormous pressures on financial markets and causing financial-related problems. The first signs of out-year problems, namely high and rising interest rates, additional strengthening of the dollar, and a worsening of the LDC and banking problems, have already begun to emerge.

(b) It is now clear that the economy has recovered at a rapid rate because four key factors were all working in the same direction—these include the extremely low rate of inflation; the enormous pent-up demand that was created during the long period of stagnation in the late 1970s and early 1980s; the stimulative effect of massive budget deficits; and the extremely accommodative monetary posture since the summer of 1982. However, as we move further into the recovery, these conditions are changing—in particular, as discussed above, I expect that the net stimulative impact of deficits will gradually diminish because of their adverse effect on interest rates; that the Fed will gradually become less accommodative; and that more and more of the pent-up demand that previously existed will have been satisfied. In effect, the situation now is reminiscent of the summer and fall of 1982, when the recession was much deeper and long-lasting than had been expected—this led many to doubt that a recovery would ever occur, even though the fundamentals beneath the surface were already becoming more favorable. The reverse is now occurring—the economy continues to grow very strongly but many of the underlying forces which will determine future economic performance are gradually worsening.

(c) Deregulation of financial markets, the increased internationalization of the U.S. economy, and floating exchange rates have produced more volatility in both financial markets and in general economic activity. Thus, conditions of the 1950s and 1960s, when economic expansions generally lasted for four or five years and recessions were relatively mild, are unlikely to be repeated in the years ahead—this increase in volatility has already been evident in the last ten years.

(d) Faster-than-expected economic growth during the recovery thus far is not the result of a sharp acceleration in the labor force, productivity, or the capital stock, or other factors which have improved future growth prospects—it simply reflects the fact that much of the resources that were idled during the long period of stagnation are being used up at a faster-than-expected rate. Inflation has not accelerated even with a rapid movement toward full employment because the overvalued dollar, deregulation, and food and energy price movements are offsetting the effects of growing demand.

The recovery is already in the process of slowing somewhat from the rapid pace thus far, reflecting the following:

(a) The growth in consumer spending is already moderating from the rapid rate of increase during most of 1983. Slower growth in consumer spending is likely to continue in response to a deceleration in real income growth due to the absence of additional tax cuts and smaller gains in employment.

(b) New housing construction had been extremely strong, primarily because effective mortgage rates have been held down by the slow response of fixed-rate mortgage rates to credit market conditions, and by the growing use of variable rate mortgages, particularly those that have shorter initial adjustment periods and discounted first year rates. However, mortgage rates are now rising—recent reports already indicate some weakening in both new sales and starts. Furthermore, the large funding of apartment construction in the Southwest will soon subside. Thus, the peak in housing starts probably occurred in the first quarter, although the rate of decline in the months ahead will be modest because employment and the growth in household formation remain relatively favorable.

(c) While I expect continued inventory accumulation, reflecting relatively low inventory/sales ratios in most industries, the rate of inventory investment will not rise substantially from current levels. This will hold down the rate of increase in output.

However, a complete petering out of the recovery during the remainder of 1984 is unlikely in view of:

(a) rising Federal and state and local government spending, especially for military and public works projects;

(b) continued increases in business investment, in response to rising cash flow and capacity utilization; and

(c) still high confidence levels and an increased willingness by households to borrow, so that even modest increases in purchasing power will translate into higher spending.

Both economic activity and consumer psychology have thus far held up relatively well since the increases in interest rates thus far have been relatively small; have been heavily concentrated (at least until recent weeks) in the long-term market, which are now less significant for economic activity; and have not spread into most consumer loans. However, I believe attitudes will weaken as short-term rates begin to increase further later this year and as they spread into the full structure of interest rates. Thus, high and rising interest rates will lead to a slowdown next year by:

(a) accelerating the decline in housing that has already been referred to—housing activity has a high multiplier effect on other sectors of the economy;

(b) causing declines in spending for consumer goods and services, especially durables—while the decline will be largest in those goods and services which are credit-sensitive and/or related to housing, additional retrenchment will likely be caused by weakened consumer confidence and the decline in household wealth;

(c) directly and indirectly slowing the upturn in capital spending which is now underway;

(d) worsening the already severe trade imbalance; and

(e) causing many state and local governments to delay public works expenditures.

These adverse effects will occur not only in part because of the gradual tightening of Federal Reserve policy, but because even the impact of rising demand on interest rates will become counterproductive as the adverse effects of rising interest rates increase. Furthermore, while rising personal interest income is bolstering household purchasing power, such income tends to be concentrated among relatively few households, and has a high marginal propensity to spend, so that it will not offset the effects of declining confidence and net worth on spending. Finally, the dramatic increase in total debt, as well as the fact that much of it is short term or floating-rate long-term debt, has dramatically increased credit risks. Higher interest rates will be particularly troublesome by draining disposable income and cash flow more than has occurred in other cycles, when overall debt levels were lower and when a much larger fraction of that debt was at fixed rates.

Thus, in sum, I believe that large and rising structural deficits, rising interest rates, an enormously overvalued dollar (on a purchasing parity basis), high and rising trade deficits, LDC debt and banking problems, excessive growth in debt (especially short-term and floating-rate long term), and the general increase in credit risks, will cause the economy to slow in 1985, with some industries experiencing significant declines. Several signs of the coming weakness in the economy have already developed:

(a) As mentioned above, the single-family housing market has softened in response to increases in mortgage rates—both sales and starts of new homes have already dropped from the previous peak and the number of unsold homes has begun to rise. This weakness in housing will worsen, and also spread to related industries next year.

(b) While much of the recent decline in commodity prices is the result of factors discussed above, there nonetheless appears to have been a modest reduction in demand over and above that caused by inventory cutbacks.

(c) New orders for durable goods (excluding military), which rose sharply during all of 1983, have been relatively flat (although highly erratic) during most of 1984.

(d) The stock market continues to remain weak—the magnitude, duration, and breadth of the decline in the market since the peak in 1983 suggests that more than a technical correction is occurring.

(e) The dollar continues to strengthen and is now at an all-time high, more than making up the modest softening that occurred earlier this year. This will aggravate an already severe U.S. trade imbalance.

The exact timing, degree, and duration of economic weakness will depend on several factors, including:

(a) when and how much the Fed decides to rein in the growth in credit;

(b) when and how much consumer confidence declines in response to higher rates;

(c) whether the stock market rebounds or declines further; and

(d) the additional effects of rising interest rates on the value of the U.S. dollar on foreign exchange markets.

At this point, a no-growth environment in 1985 remains most likely, although an outright recession cannot be ruled out. Even if a recession does occur, however, it is not likely to be anywhere near as sharp as in 1981-82 as:

(a) the depth of the 1979-80 and 1981-82 recessions were in part the result of the sharp increases in oil prices and other factors which produced double-digit inflation and sharp declines in household purchasing power—this will not occur in 1985; and

(b) monetary policy is not likely to be as restrictive as it was in 1981.

The attached table and charts summarize my short-term forecast for key economic indicators.

Long-Term Outlook

The long-term economic outlook will be affected by the following: **First**, recent developments suggest that potential long-term output, even under ideal economic policies and assuming full employment by the end of the decade, is considerably less than is implied in the most recent Administration long-term forecast, primarily because of the likelihood of relatively slow growth in both the labor force and productivity. **Second**, the amount of slack currently in the economy is also less than previously had been thought. Thus, the maximum possible for average real growth during the remainder of the decade is probably between 3.0 and 3.5 percent per year, significantly less than the more than 4 percent currently being assumed by the Administration. Furthermore, in my view, it is highly unlikely that even more modest rates of growth will be achieved on a consistent basis with current economic policies, especially the bleak outlook for the Federal deficit.

Labor Force Growth: The growth in the labor force slowed dramatically in 1983, even though labor force growth generally tends to accelerate during the first year of economic recoveries. Many forecasts of substantial long-term economic growth are in part based on the assumption that the civilian labor force will continue to grow rapidly during the 1980s, following the average 2.5 percent per year increase during the 1970s. However, it is possible that the recent performance is the start of a new period during which labor force growth will be far more moderate. This reflects:

(a) The growth in the adult population during the remainder of this decade will be far less (0.9 percent per year) than the near 2 percent rate of increase during the 1970s, primarily reflecting the fact that the big bulge in the labor force caused by the baby boom is now over.

(b) The divorce rate has fallen during the past year for the first time since the 1950s. Shifting demographics and other factors suggest that while, the downtrend may not continue, it is unlikely that the divorce rate will rise as it did during the prior 20 years. This would likely cause a significant slowdown in the female participation rate.

(c) Rising real incomes and lower unemployment may also cause the female participate rate to rise much more slowly than during the 1970s, when a large number of women entered the labor force either because of the squeeze on family purchasing power caused by accelerating inflation or because of rising layoffs.

As a result of these factors, I believe that labor force growth of slightly more than 1.0 to 1.5 percent per year is a more realistic assumption for the remainder of the decade than the near 2 percent increase implicit in other forecasts.

Productivity Growth: Even with a strong emphasis on efficiency and cost-cutting, and relatively fast output growth, the increase in productivity during this recovery thus far has not been outstanding, suggesting that the improvement in the underlying trend growth in productivity has only been modest. Furthermore, the long-term outlook for productivity will be held down by the fact that many of the people who were laid off in recent years were the least efficient and experienced--these are likely to be those rehired if the economic recovery continues. In addition, 1983 was characterized by a sharp increase in manufacturing output in relation to the increase in total GNP, which bolstered overall productivity levels. A

shift toward services as the recovery continues will diminish the significance of this factor. Thus, it appears that the improvement in the underlying trend in productivity growth may be a relatively modest 1 to 1-1/2 percent per year. While this is considerably better than the performance during much of the 1970s, it nonetheless remains far below the near 3 percent per year increases experienced during the 1960s. It also suggests more moderate long-term economic growth than some forecasters have assumed.

On balance, it appears that the growth in potential output during the remainder of the decade will be less than 3 percent a year. Furthermore, despite the fact that the recovery is only 1-1/2 years old and started from a relatively depressed level of economic activity, it is also likely that the amount of slack that current exists in the economy is fairly modest. This reflects the fact that capacity is growing very slowly, due to the elimination of a considerable amount of previous capacity in many industries and the relatively depressed level of capacity-related investment in recent years. In addition, the employment-to-population ratio is now almost 60 percent, close to a record high, and far above the rates that prevailed during most of the postwar era, despite still high unemployment.

Thus, on balance, it is highly possible that the maximum growth rate the economy can experience for the remainder of the decade, assuming favorable economic policies and a return to full employment by the end of the period, is only slightly above 3 percent. This is considerably less than the 4 percent plus average that underlies the Administration budget projections made earlier this year.

The Impact of Budget Deficits: It is highly likely that current economic policies, principally the bleak outlook for the Federal deficit, will prevent the economy from reaching an even more conservative estimate of potential GNP before the end of the decade. One school of thought is that the economy can continue to expand, even with significantly higher interest rates, because the added fiscal stimulus from rising structural deficits would offset the adverse effect of rising interest rates—only a shift in the composition of output would occur. However, even if this scenario is correct, it would likely reduce long-term growth below current expectations because the shift in output mix would be toward more consumption and less investment—slower growth in investment would reduce long-term growth by reducing industrial capacity to support such growth, as well as by limiting the increases in productivity that result from new investment. Furthermore, the large and growing interest payments to foreigners would further reduce long-term growth by sapping resources away from the United States.

While such a reduction in potential long-term growth from an already modest rate would almost certainly thus occur as a result of growing structural deficits, I believe that the risks are even much more severe; in my view, as discussed earlier, the increase in interest rates that are already occurring as a result of Federal deficits, as well as those still to come, will very likely cause a weaker economy next year. While the economy is now less sensitive to a small change in interest rates than it was before financial market deregulation, the evidence of recent years clearly indicates that a large change in interest rates will have significant effects on the economy. This was witnessed during 1981, when the sharp increase in long-term rates became the major factor producing a deep recession during the second half of 1981 and 1982, and in 1983, when a sizable part of the recovery process was a direct result of the decline in rates in late 1982. Large and rising Federal deficits will also have other potentially adverse effects on the economy during the years ahead.

(1) Because of the very rapid growth in interest payments, Federal expenditures and deficits have become far more sensitive to interest rates than has been true in the past. This has created an inflationary bias—pressures on the Federal Reserve to avoid higher interest rates in order to prevent even bigger budget deficits would require faster and faster growth in the money supply and higher, long-term inflation.

(2) The United States is in danger of becoming hostage to developments overseas. In particular, U.S. policies in the future may have to be geared to prevent efforts by foreigners to reduce their holdings of dollar-denominated assets, such as preventing a decline in the exchange rate of the dollar and encouraging higher and higher interest rates. These polcies would, of course, conflict with other goals, including the need for a correction in the value of the dollar in order to erase the competitive disadvantage of U.S. companies in world markets.

(3) The longer it takes to reduce future deficits, the greater the risks become, and the harder they will be to reduce because of continued increases in interest expense and the likelihood of an economic decline that will make the deficit outlook even worse.

THE INFLATION OUTLOOK

Concerns of a major acceleration in inflation later this year have increased because of:

(1) rapid growth in the money supply since mid-1982;

(2) rising utilization rates, which are beginning to strain capacity in many industries;

(3) fears of a big pickup in wages; and/or

(4) the worsening of hostilities in the Middle East.

However, I expect inflation to remain very modest in the near term, averaging no more than 5 percent. This reflects:

(a) While money growth has been rapid during the last two years, even after eliminating distortions caused by financial market deregulation and innovation, such growth in money during the recession and early recovery period will not be inflationary, especially since I expect the Federal Reserve to slow money growth after the election.

(b) While utilization rates are rising, and some industries are operating at or near full capacity, the overall rate of capacity utilization is still only about 82 percent, which makes widespread shortages and bottlenecks unlikely in the very near term. This is particularly true in view of the fact that utilization rates remain quite low in most foreign countries—coupled with the overvalued dollar, this permits an increase in imports to offset potential shortages in the United States.

(c) While some increases in wages are likely in view of falling unemployment and rising profits, historical experience shows that an acceleration in wages occurs slowly over time. This reflects the fact that many union contracts are three years in length and that nonunion wage increases tend to ratchet upward quite slowly. Furthermore, unemployment still remains high in many sectors; cost-of-living adjustments remain relatively small; many companies are

continuing strong efforts to hold down costs; and deregulation is exerting downward pressure on wages in many industries. Finally, even a relatively large settlement in the auto industry is not likely to cause sharp upward pressure on wages elsewhere because I believe that a significant portion of the likely settlement will include a one-time bonus payment for workers rather than extremely large annual wage increases.

(d) Despite the conflict between Iran and Iraq, oil prices are not likely to rise substantially until later in the decade, especially since oil shipments through the Strait of Hormuz do not appear to have declined significantly—even in the unlikely event that the Strait is shut down, increased output from other countries and a drawdown of current inventories will prevent widespread shortages for at least six months, thus limiting the magnitude of any prices increases.

The U.S. economy also remains extremely competitive, primarily because of deregulation in many industries and the direct and indirect effects of an overvalued dollar. Thus, companies are having more difficulty raising prices than at similar points in earlier recoveries. Furthermore, in view of recent increases in interest rates (and the likelihood of additional increases), a sharp decline in the value of the dollar on foreign exchange markets in the very near term is unlikely. This will continue to hold down the inflation rate in the United States. In addition, productivity continues to grow and, although additional increases are likely to be more modest, the underlying trend growth remains higher than in most of the 1970s. Finally, while food prices will move up again later this year, the increases are likely to be less than previously expected because of relatively weak demand for meat (despite rising real incomes). This will not only hold down the increase in meat prices but, assuming relatively good crop yields, will also act to weaken grain prices. Thus, an acceleration in inflation to rates approaching double digits during the remainder of 1984 and early 1985 is extremely unlikely.

On a longer-term basis, I are somewhat less optimistic about the outlook for inflation—I continue to expect an average of 6 to 6-1/2 percent during the second half of the decade. This reflects the likelihood that the dollar will eventually decline on foreign exchange markets, that oil prices will begin to move upward again later in the decade, that productivity growth will slow further relative to recent performance, that the costs of nuclear power plants will eventually cause large increases in the cost of electricity in many areas, that commodity prices will eventually rise from current depressed levels, and that profit margins will move back closer to historical levels. An acceleration to the double-digit rates experienced in the 1970s is unlikely, however, because the massive increases in energy prices, and the absence of almost any growth in productivity will not likely be repeated, and because of the more competitive nature of the U.S. economy.

POLICY RECOMMENDATIONS

I believe that the most essential change in economic policy that is necessary to promote a sustained economic expansion is early action to significantly reduce future deficits. This is especially true because most of the factors which are jeopardizing the recovery (i.e., high and rising interest rates, LDC debt and banking problems, and the overvalued dollar) are in great part the result of deficits.

In my judgment, it is necessary, as soon as possible, to enact sufficient spending cuts and tax increases in order to reverse the pattern of rising deficits that is likely under current policies. These actions should be sufficient to produce a gradual decline in the deificits, beginning in 1985, of approximately $30 to $40 billion per year from the preceding year, so that the deficit will be about $50 billion by the end of the decade, in comparison with the approximately $250 billion that will materialize under current policies and reasonable economic assumptions. Even after taking into account the fact that reductions in deficits will build on themselves by reducing interest expense in succeeding years, the actions required will be very substantial. In my view, while I favor as much in the way of spending reductions as is possible, it will be impossible to close the deficit gap sufficiently just on the spending side, even if a significant cutback or stretching out in the military buildup is adopted. Thus, relatively large tax increases will likely be necessary as well.

I believe that in addition to a stretching out of the military buildup, that any additional budget cuts that are made be concentrated in the area of entitlements, particularly for health and pension programs. I advocate capping the cost of health care and implementing other reforms that will significantly reduce the cost of medical care in the years ahead. Furthermore, I think it is essential that we gradually increase the retirement age for full Social Security benefits as soon as possible, that the indexing formula for Social Security and other entitlement programs be scaled back, and that a means test be strongly considered for many of the entitlement programs. Finally, pension benefits for government employees will have to be reduced as well.

On the tax side, I believe that tax increases should be consistent with the following objectives:

1. To the extent possible, any increase in personal taxes should be accomplished by broadening the tax base rather than by incrasing marginal tax rats. This can be done primarily by eliminating many of the loopholes, tax shelters, and deductions that now result in sizable revenue loss.

2. Since I believe that the distribution of the tax burden has been shifted dramatically in recent years away from the upper income groups toward those with lower and middle incomes, I would strongly oppose any tax increases in the years ahead which are relatively regressive. In fact, I would hope that the tax changes which are implemented will at least partially reverse the trend of recent years, especially since large, regressive Social Security tax increases are already scheduled in the years ahead.

3. I believe that at least a portion of any tax increases should be directed at corporations in view of the sharp decline in the corporate tax burden in recent years. Since the tax burden across industries is highly uneven, consideration should be given to implementing a minimum tax for corporations as part of an overall corporate tax increase.

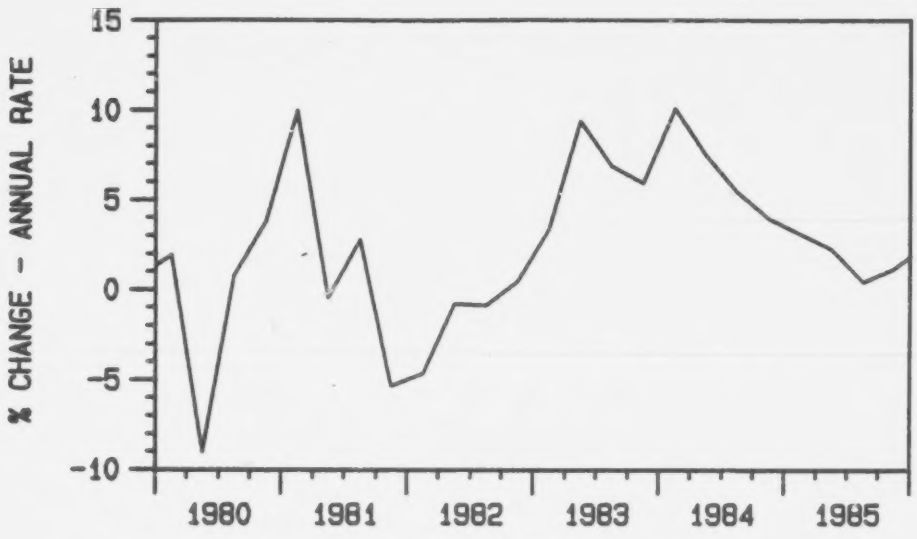
4. Any program of tax increases that can be implemented as part of tax reform which makes the tax structure both simpler and fairer would be most welcome. A straight flat tax, or a consumption tax, however, would be inappropriate in my judgment because they would likely make the tax structure even more regressive than is currently the case.

In my view, these objectives can best be met by enactment of the Bradley-Gephardt proposal, with the rates set high enough to generate the revenues needed to reduce future deficits to acceptable levels after necessary spending cuts are implemented.

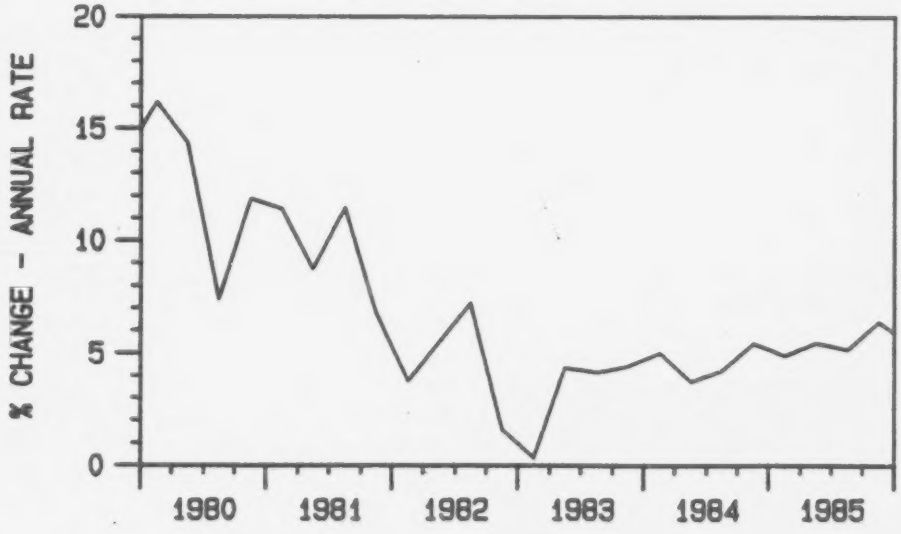
Forecast Summary Table
(% Change)

	1981	1982	1983	1984	1985
Real GNP	2.5	-2.1	3.7	7.4	3.2
Industrial Production	2.6	-8.1	6.4	10.9	2.6
Real Consumption	2.0	1.3	4.8	5.7	3.7
Real Fixed Investment	5.5	-4.7	2.5	20.7	12.2
CPI	10.3	6.2	3.2	4.4	5.1
GNP Deflator	9.6	6.0	3.8	3.8	4.8
Pre-Tax Profits	-5.7	-25.2	22.8	24.6	3.0
Unemployment Rate (%)	7.5	9.6	9.4	7.1	6.8
Prime Rate (%)	18.9	14.9	10.8	12.5	15.6
Auto Sales (millions)	8.5	8.0	9.2	10.6	10.1
Housing Starts (millions)	1.10	1.06	1.70	1.79	1.40

REAL GNP



CONSUMER PRICE INDEX



Representative WYLIE. Thank you very much. Mr. Chimerine.

Now I think we will hear a little more optimistic view from Mr. Michael Evans, president of Evans Economics. Would you proceed in your own manner, Mr. Evans.

STATEMENT OF MICHAEL K. EVANS, PRESIDENT, EVANS ECONOMICS, INC., WASHINGTON, DC

Mr. EVANS. Thank you very much, Mr. Chairman. You are indeed correct in your assertion that I will be more optimistic. This is perhaps the first time I have ever been more optimistic than Larry has, but I think there are good reasons for being so today.

There is no question that the economy has performed fabulously during the last six quarters, much better than anybody expected. I think that the most significant factors have been the very sharp decline in commodity prices and the general reduction in inflation in the last 3 months. We all know that the producer price index has shown no increase at all during the second quarter, commodity prices are down 10 percent or more from their peaks, and the consumer price index continues to advance at a rate of only 2 percent to 3 percent per year at an annual rate.

Now this wasn't supposed to happen this way. If we go back and examine post-war business-cycle history, we find time and again that approximately six to seven quarters after the economy starts to increase vigorously we begin to get a rise in inflation. This happens almost every time. And if we date the business-cycle through from November 1982, as the National Bureau does, ordinarily that would have led to higher inflation in the second half of this year. It simply is not happening. Inflation in the second half of the year is going to be 4 percent. It could even be less, based on factors in commodity prices which have surfaced recently.

So what happened? How is it possible that we have so little inflation when the upturn over the past six quarters has been much more vigorous than is usually the case?

Some people refer to the fact that capacity utilization is a little lower than usual, that unemployment is a little higher than usual. The economy has improved so rapidly that these are no longer material factors. In fact, the unemployment rate probably will decline to about 6 percent by the end of this year, and in my book that is fairly close to full employment. So I don't think we can go back to the outmoded suggestion that capacity utilization and unemployment are keeping inflation low. I think there are other factors.

One of the major factors has been the open economy. The trade deficit, of course, is quite serious. It represents about $130 billion this year. But that is not all bad. We have to look at the positive side of the trade deficit, and that is that we have competition from foreign suppliers that definitely are keeping prices down. Domestic producers don't have a chance to increase their prices without being hit by a flood of imports. And as a result, inflation is much lower than it would be.

Furthermore, this will continue on for the next year or two. After all, the rest of the world recovery is almost nowhere. In fact, we are the envy of the rest of the world. The foreign leaders cannot understand, after having spent the last 3 years criticizing President

Reagan's program, how it is possible we have generated 7 million new jobs in the last six quarters. They don't say it's voodoo economics, but they kind of wonder how it could have happened.

The point is that we have a very strong economy. If you take away the additional goods that the rest of the world is selling the United States, there has hardly been any increase at all in the worldwide economy, and as a result of this there is plenty of spare capacity worldwide which continues to keep prices lower.

The other factor is that I think both labor and management learned from the lessons of the Great Recession. If we look at productivity statistics we always see a big increase in productivity in the first year of recovery. Why is that? Because of the lag between output or employment. But also because labor and management are still aware of the bad times they just went through, and so they are very cautious. Productivity is high and management's skills are honed to keep prices down and so forth.

Usually after a year or two this tends to go away. When the economy is closer to full employment, profit margins keep increasing, there is a natural tendency to kind of slough off a little bit and not pay so much attention to these cost factors. I don't think that will happen this time. I think that the Great Recession spawned a whole new way of looking at productivity with long-range plans, the second and third stages of which are now being implemented.

Another factor which I think is very important but sometimes doesn't get mentioned is what we could call the high technology revolution, a direct result of twin cuts in capital gains taxes that we had, one in 1978 and one in 1981. These tax cuts have spurred the venture capital industry; they've literally increased it by a hundredfold. We had over $10 billion worth of new money into venture capital, private placements and stock market offerings last year. A lot of these inventions are still coming to fruition, but they've had the effect of increasing the rate of productivity growth.

So when you consider all these factors, one of the basic determinants of inflation, which is high productivity growth, will continue on for several years. With a faster than average growth in productivity for the years ahead and the countervailing power, if you will, of foreign imports, I don't think we are going to have much inflation.

One issue raised by many people is that we have had a substantial increase in interest rates and yet the economy seems to be going on as fast as ever. Particularly consumer spending is quite strong. How could this be?

Well, one very simple answer is that interest rates paid by consumers have actually fallen during the last year. For those of you who are following my testimony, I will refer you to table 1 of my prepared statement, which shows selected interest rates in May 1983 and in May 1984, which is the latest figures we have for rates charged to consumers.

This table shows very clearly that market interest rates—the prime rate, commercial paper rate, Government bond rate, and so forth, have increased almost 3 percent, over this period. But yet the rate paid by consumers on loans to commercial banks have gone down in every case. These are Federal Reserve Board figures taken right from their releases. And in all four of the categories

the rates have declined. In large part this is due to the deregulation of the banking sector. With increased competition, the spreads on consumer loans have narrowed substantially from where they were a year ago, 2 years ago, and certainly from where they were a decade ago.

So do high interest rates matter to consumers? I would say the answer is yes, if they've gone up. However, they've actually gone down. So this is one reason the economy is strong.

Many economists would grant this point—but what about the future? Are we going to have higher interest rates? I don't think so. I believe that market interest rates, the prime rate, long-term bond yield, mortgage rate, and so forth and so on, will decline between 1 percent to 1½ percent from now until the end of the year. We've already had a rally in bond markets. My esteemed colleague, Mr. Chimerine, believes this is temporary. I don't see it that way. I believe that this is the start of lower interest rates.

Inflation is much better under control than the financial community expected. If you go back and talk to the people that traded financial instruments 3 or 4 months ago, almost without exception they thought the rate of inflation was going to go to 6 percent next year, and possibly as high as 8 percent.

Well, that forecast is now changed, due to the decline in commodity prices we've had and due to the other factors I've mentioned in my testimony, and as a result inflation will stay around 4 percent next year. So as a result of that we are going to have a somewhat slower growth in economic activity, but still a good level.

My prediction for next year would be about 4 percent GNP, but down from the 8.8 percent we've had in the first half of this year. The economy will enjoy stability in inflation and a further improvement in the deficit picture; and as a result of these factors I believe interest rates will come down slightly. They certainly will not return to their old levels, but even a decline of 1½ percent will be enough to supply further strength to the economy.

Well, I've painted such an unexpectedly bright picture, I guess the last question is, does this ever stop, or does it go on forever and ever? Well, I think there are some problems that we have to bear in mind.

First, right now the dollar is very strong. Part of that is due to economic factors; part of that is due to psychological factors. If the dollar were to weaken, then inflation would come back, the countervailing power of imports would be reduced, and the amount of investment foreign investors are using to pick up our deficit would also be reduced. So the dollar must remain strong.

Second, we do have to come to grips with the deficit problem, and I think what the Congress does in 1985 will be very important in terms of tax reforms. I personally have testified before in favor of a modified flat rate tax. I don't know if Congress will go that way or not, but I want to say unequivocally that in my opinion a surcharge would be counterproductive; it would not solve the problems of the economy. So I think what the Congress does is very important.

Third, I think that the Fed has to keep an even keel and it cannot let credit growth get out of hand. Right now the Fed policy is, I would say, essentially the correct policy. They tightened a

little bit in March. That defused inflationary expectations, which was a positive sign. I think they will ease a little bit once they see that the economy has cooled off. But they can't let things get out of hand; they can't be like previous Feds who locked the barn door after the horse of inflation had galloped off in the previous years. That won't work.

So if we have these three factors, a strong dollar, meaningful tax reform, and a stable monetary policy, I would see no reason why the recovery could not continue into 1985 and 1986 as well.

Thank you.

[The prepared statement of Mr. Evans follows:]

PREPARED STATEMENT OF MICHAEL K. EVANS

Real GNP is now expected to rise at an annual rate of 6% for the rest of the year and continue to advance at a 4% rate in 1985, with consumer spending serving as the principal driving force. Inflation will remain at 4% during the second half of 1984.

Consumption remains extremely strong; higher interest rates have not made a dent in this sector for several reasons, not the least of which is that the rates charged to consumers have actually declined during the past year, as shown below. New orders are definitely winding down, but the strength of new projects started last year will raise real capital spending about $8 billion this quarter and next, almost as strong as the average increase of $9 billion during the past four quarters. Our forecast assumes no further gains in housing, in view of the slight decline in housing starts over the past four months, and a further decline in net exports, although at a much slower rate than the $6 billion average drop during the past year. Inventory investment probably will ease off slightly, although retail inventories will expand in anticipation of a strong Christmas selling season again this year; that could push real growth even higher. State and local government purchases will rise about $1 billion per quarter and defense spending will increase about $2 billion per quarter in real terms. It all adds up to about a 6% growth rate.

Inflation will remain flat. The 0.2% gain in the June CPI was presaged by three straight months of no change in the PPI-finished goods index and the 2.1% increase in the implicit consumption deflator for the second quarter, but is impressive nonetheless. The inflation statistics continue to be exceptional. Wage rates have risen at only a 3.1% annual rate during the first half of the year, and nonfarm unit labor costs rose only 0.3% in the second quarter. The deflation in commodity prices is an accomplished fact, and will continue at least through the summer. And no one wants to buck the strength of the dollar, as it reaches levels unseen since the days when the U.S. was still on a fixed exchange rate standard.

The obvious question is how long this tightrope act can be continued. We still have the twin ticking time bombs of the Federal budget deficit and the international debt crisis hanging over our heads, but for the moment they have been defused. The key variable here is the value of the dollar, as discussed below in more detail. As long as it stays in its present range, foreigners will continue to fund the Federal budget deficit, and inflation will not worsen. The factors holding the dollar at current lofty levels are largely psychological, based on the perception that the U.S. economy is strong, inflation is under control, and the Reagan Administration is committed to providing a healthy climate for capitalism. This virtuous spiral can reverse direction at any time, but we do not think that will happen until the Fed finds it necessary to pull the plug on excessive credit demands -- which probably will not occur until 1986.

In addition to real growth of 6% for the remainder of this year, the first quarter of 1985 is also likely to be quite strong, once again

reflecting the carryover from surging consumer demand during the holiday season. After that, the slowdown in housing starts and decline in new orders that has already began will reduce growth to about 4%, which is still an optimal long-term rate. We can find no particular reason for inflation to accelerate beyond the 4-5% range even in 1985 unless the dollar were to soften markedly. Indeed, if the blend of monetary and fiscal policy could be optimized next year in terms of meaningful spending cuts and tax reform, the current equilibrium could continue indefinitely. Here, however, we feel that the Administration and Congress will not be able to pull off this miracle, and the inflationary cost pressures that will creep back into the system can be exorcized only with another recession in 1987.

WHY CONSUMER SPENDING WILL REMAIN STRONG

Returning to the shorter term outlook, we believe that consumer spending will provide the backbone for strong growth during the next three quarters, just as it has provided the principal impetus for the recovery to date. In this regard it is useful to clear up a common misconception, namely that the current recovery has been investment rather than consumer-driven. It is easy enough to see how this misconception got started; it has since been busily promoted by the supply-siders.

During the first six quarters of this recovery, real capital spending has increased at an annual rate of 16.3%, while consumer spending has advanced at only a 5.7% rate. Since capital spending usually lags the cycle, this is offered as prima facie evidence that this upturn is different, the reason presumably being the Reagan tax cuts.

Yet one of the major reasons that capital spending has rebounded so quickly was that it had collapsed so thoroughly during the previous three years. Combining the effects of both the short 1980 and much more serious 1981-82 recession, we find that the ratio of capital spending to GNP (the investment ratio) declined from a peak of 12.1% in 1980.1 to a trough of 10.9% in 1982.4; it has since recovered to 11.5%. In other words, the investment ratio is still 0.6% below its level on the eve of the 1980 recession. This gap is almost identical to the average postwar shortfall of 0.7% between the investment ratio after six quarters of recovery and its peak value just before the previous recession. Viewed in this light, the investment ratio has not exhibited any unusual pattern this time; it has simply recovered from an unusually severe decline caused by high interest rates and stringent credit conditions.

The consumption ratio, on the other hand, has risen substantially in the current upturn, increasing from 62.9% in 1980.1 to 63.8% in 1984.2. Furthermore, consumption has outrun income, as the personal saving rate fell from 6.2% in 1982 to 5.0% in 1983 -- the first time since 1955 that the personal saving rate declined during the first year of recovery. While investment was falling out of bed during the recession, consumer spending in real terms generally kept increasing, although at a much slower rate and not without severe declines in purchases of durables.

The major reasons why consumption has been so strong -- and why we expect this pattern to continue for at least the next year -- can be summarized in the following list.

1. An unprecedented availability and use of consumer credit.

2. A decline in interest rates charged to consumers by banks in spite of the rise in market interest rates. Only part of this is the adjustable rate mortgage phenomenon; rates on short-term bank loans have also decreased.

3. A very low rate of inflation, particularly recently: the implicit deflator for consumption of goods actually declined in the second quarter.

4. The positive attitude generated by an unprecedented decline in unemployment and a record 7 million jobs created.

5. More than usual amount of buying representing delayed purchases during the recession, which lasted for three years instead of the usual one. Also, many families are trying to regain past living standards that eroded over the past four years, as witnessed by a 10.2% decline in median family real income from 1978 through 1982.

Of these items, the most important are probably the first two: the availability and cost of credit. During the past year, consumer credit has increased $64.2 billion, or 18.3%. This may not seem much higher than the increases of 16.5% and 18.8% during similar stages of the previous two business cycle recoveries, but inflation was much higher then. The additional liquidity became available as follows.

The banking system woke up early in 1983 to find an extra $50 billion on their doorstep; these additional deposits were due to deregulation of the banking sector and the initiation of Money Market Deposit Accounts. This sum did not merely reflect the switching of funds from one type of deposit to another; it represented additional inflows to the banking system from unknown sources, attracted by the high rates of return.

Banks could have lent this money to the business community, but early in 1983 inventory investment was still declining and corporate cash flow was well in excess of current needs -- a situation that has changed drastically in the past six months. As a result the banks turned to consumers, and to show they meant business, banks lowered their interest rates, as shown in Table 1. This was accompanied by a drumfire of new credit card applications, with the result that the dollar volume of consumer credit rose 25% last year and is increasing at a 30% to 35% annual rate thus far in 1984.

TABLE 1

SELECTED INTEREST RATES, MAY 1983 AND 1984

	May 1983	May 1984
Rates Charged by Commercial Banks:		
48-month New Car Loan	13.90%	13.53%
24-month Personal Loan	16.57%	16.35%
120-month Mobile Home Loan	15.84%	15.54%
Credit Card Plan	18.79%	18.71%
Effective Rate of Mortgages, FHLBB	12.67%	12.15%
Market Rates:		
Prime Rate	10.50%	12.39%
Commercial Paper Rate, 3 Months	8.53%	10.65%
3-month Treasury Bill	8.19%	9.82%
30-year Treasury Bond	10.53%	13.43%

Furthermore, in the areas where interest rates do matter, we have strong if not unequivocal evidence of some slowdown in the economy. Housing starts have declined from a peak rate of 2.26 million in February to 1.90 million in June; the decline has not been steeper because the effective rate on mortgages has declined. New orders for durable goods, after having increased 44% from the trough of the

recession in November 1982 to February 1984, have actually declined 3.3% since then, precisely the time when market interest rates have risen. And of course the performance of net exports has been devastating, with total net exports falling from $20 billion in 1983.1 to -$58 billion last quarter, as the result of higher interest rates and the stronger dollar.

We think consumers are still sensitive to higher interest rates, but they are actually borrowing at lower interest rates than a year ago. And while the piper must still be paid on adjustable rate mortgages when those low first-year rates rise to market levels, so far the lower rates have had the net effect of providing more rather than less funds for other consumption. The increase in rates has had a moderate effect on slowing housing starts and a more vigorous one on reducing new orders, but these will not translate into slower growth in investment until late this year; and by then the Christmas season shopping euphoria will disguise the slowdown until February or March 1985.

Because short-term interest rates are still below what banks are charging consumers, they could rise somewhat further without having any noticeable impact on consumption. After about another 1% increase, however, banks would have to raise their loan rates, as margins would then be too narrow to cut further. However, we do not think rates will move higher, as a significant decline in bond yields is already underway.

We are certainly not congenital optimists when it comes to forecasting interest rates, and in fact as soon as the recovery started at the end of 1982 predicted that rates would rise even during the early

stages of recovery -- a forecast which was at odds with both the historical perspective and the consensus opinion of the time. The reasons were the improvement in the level of economic activity, a rise in the rate of inflation, an abnormally low net national saving rate, and a Fed anxious to show it would not buckle under to inflationary pressures just because it had put the economy through the wringer once.

Now, however, all of these factors have been reversed. The slowdown in real growth from 8.8% in the first half to an estimated 6% in the second half is not that dramatic and by itself would not be sufficient to reduce interest rates, but it is a minor contributing factor. More important, inflationary expectations have been thoroughly routed and, as discussed in the final section of this testimony, inflation will remain at 4% in the second half and in the 4-5% range next year. Considering that many financial market analysts were expecting an increase in inflation to 8% or so next year, this serves as a massive reversal of expectations and one which is just now beginning to filter through the bond market.

With the extremely rapid growth rate of the economy, the net national saving rate no longer looks so dismal, although it is still well below average postwar values. However, it has increased from 1% during the dark days of late 1981 to 4% presently, and will probably rise to almost 5% in 1985. In the meantime, the extremely strong dollar is generating approximately $100 billion per year in foreign funding of the deficit. While that could end overnight if the dollar were to soften, we do not yet see that occurrence on the horizon.

Finally, we believe that Mr. Volcker and company have proven to the markets that the Fed can tighten <u>in advance</u> of any inflationary buildup,

just as it did in late March. As a result, the Fed has regained a good part of the confidence at least the international financial community for the Fed that was sorely lacking during the past 15 years. While this reborn trust is indeed fragile and can still be shattered by the next false step, it gives the Fed some additional flexibility in lowering rates later this year.

STABLE INFLATION THROUGH 1985

Of course, this whole grand scenario is blown to bits if inflation materially exceeds the 4% to 5% range for the next several quarters. Higher inflation means that interest rates would increase, the Fed would have to reinstitute tight credit policies, and both consumption and investment would soon go down for the count. Since stable inflation is the key to our optimistic outlook, this subject is now explored in greater detail.

In our view, the most surprising economic development of the year has not been the strong growth of the economy but rather the continued high level of the dollar. Ordinarily one would expect the dollar to weaken as domestic growth accelerated; this generally raises imports more than exports, and the resulting imbalance reduces the value of the dollar. However, the interest rates differential was evidently high enough to attract a sufficient amount of foreign funds -- and keep enough domestic funds at home -- to offset much of the trade balance, and the perception that inflation would be kept under control received a major boost when the Fed tightened in late March before inflation accelerated. World-class speculators responded very strongly to this development, sharply reversing their selling of the dollar and dumping precious metals instead.

These international developments are of primary importance. For far too long, economists of virtually all stripes have been captive to the outmoded domestic paradigm that rapid growth must necessarily worsen inflation because the higher level of output requires the use of less productive labor and capital resources, which raises costs and prices.

In the global network where the U.S. now finds itself securely ensconced --and anchored by the above-mentioned strength of the dollar -- consumers can effectively utilize a worldwide network of producers, many of whom have much more modern capital than the average plant and equipment in this country and can draw from a much more highly motivated work force. Because of this opportunity, the current surge in growth in this country will have a far different effect on inflation than the past. First, excess worldwide capacity means that the domestic economy can expand much more rapidly without hitting the usual level of bottlenecks and shortages. Second, the option of purchasing abroad can serve as a very useful club to both management and labor, inhibiting them from returning to the old patterns of less efficient methods of production as the recovery matures.

It has always been axiomatic that real GNP can grow much faster in the early stages of business cycle upturns without creating any problems because of the absorption of excess capacity. In the current recovery, however, not only domestic capacity can be absorbed; international capacity is available as well. Figures for capacity utilization overseas are much harder to obtain than for this country, but the unemployment rate in virtually all major industrialized countries except Japan -- Canada, France, Germany, Italy, and Great Britain -- is now higher than in the United States. Even more important is the tremendous

growth of Third World capacity during the past decade and the critical need of these countries to generate scarce foreign exchange in order to pay back their debts to U.S. and European banks. Hence worldwide capacity will play a much more important role than ever before in terms of availability of materials and other factor inputs if the economy continues to grow at well above average rates.

Unlike manufactured goods themselves, labor is not generally thought to be exportable, and for services and construction, that is generally correct. However, in the past five years this country has essentially exported 1 out of every 10 jobs producing goods to foreign countries. Net exports of goods for 1984 will be approximately -$120 billion; five years ago the figure stood at only -$25 billion. While it is true that without this import switch most of the LDC's simply would have closed down shop, big business can use this threat of exporting jobs as a very effective club over the heads of labor unions that might be intransigent about pushing for inflationary wage increases in upcoming contracts.

In addition, it would appear that total capacity in the domestic economy is growing somewhat faster than the 3% figure which now stands at the heart of many long-range planning assumptions. The 3% figure is arrived at approximately as follows, using the standard 2/3 for labor and 1/3 for capital as factor shares. The equilibrium growth rate for the labor force is about 1½% per year and for capital stock is about 3% per year, while the underlying growth in productivity not associated with increases in factor inputs is about 1% per year. This gives an estimated 3% annual increase in total capacity.

A more generous interpretation, however, would have the labor force growing at 2½% per year and capital stock at 4% per year, in which case the growth rate for total capacity would move up to 4% per year. The most recent figures on labor force growth do relatively little to illuminate the underlying rate. During the first year of the Great Recession, the labor force grew only 1.6 million, compared to an average increase of 2.6 million during the past five years. During 1982 it grew 2.0 million, which was a somewhat better performance, but most of that gain occurred in the first part of the year, and the labor force increased only 0.3 million from May to December. Furthermore, these minuscule gains continued into the first few months in 1983, so that from May 1982 through May 1983 the increase was an almost invisible 0.4 million. Demographers came out of the woodwork to tell us about how the reduction in the number of teenagers had started a year or two ahead of schedule, and economists were wont to explain how the Great Recession had fostered an unprecedented number of forced early retirements, which may indeed have been the case.

However, starting in June 1983 the labor force started to rise rapidly again and has increased 3 million in the past 12 months. Averaging the 1980-1984 experience indicates an average annual increase of about 1.8 million, or about 1.6%. However, the recent surge in the labor force, coupled with the 7 million jobs created over the past 18 months, suggests that labor force growth may continue above 2% in the coming quarters in spite of the general decline in the number of teenagers entering the labor force.

According to the Commerce Department estimates, capital stock grew only about 2% in 1982 and 1983, the lowest two-year sequence in the

postwar period. This occurred in spite of a recovery in the capital spending ratio last year which brought this ratio within hailing distance of the average levels of the 1970's, when capital stock grew in excess of 4% per year. The reason for this discrepancy occurs because of the shift to short-lived assets: computers, and cars and trucks instead of heavy industrial plant and equipment. This trend will undoubtedly continue into the future, but industrial equipment purchases started to pick up in 1983.4 and have continued to advance strongly in 1984.

The final element used to calculate total capacity -- non-factor induced productivity -- is also showing some signs of life. We have used this term because productivity is usually defined as output/employee-hour, and hence includes the contribution of capital. This residual term excludes these other factors, and reflects less government regulation, new technological developments, improvement in the work ethic, and so on. Because this figure is a residual and the productivity figures are at best rough estimates derived from disparate data sources for output and labor input, they must be handled with extreme care. However, if the underlying growth in productivity (including capital but extracting from cyclical growth) has been about 2% in this recovery, and capital stock growth has contributed only about 2 x 1/3, or 2/3%, about 1 1/3% annual growth in productivity would be due to technological and regulatory factors.

In other words, the relatively modest improvement in productivity during the beginning stages of the current upturn is due to the very slow growth in capital stock, not the residual factors. Should capital stock growth pick up materially, total capacity could indeed expand at

the 4% instead of the 3% mark, and hence total growth in productivity would also expand. While this is not an earthshaking event, it would play a material role in keeping inflation at bay.

The argument that inflation is likely to remain well under control throughout 1984, and probably into 1985 as well, can thus be tied to three factors. First, the tightening of monetary policy before the signs of inflation appeared has dampened inflationary expectations that would otherwise emanate from a 5½% Federal budget deficit ratio. Second, the strong dollar will not only keep import and import-substitute prices under control, but will provide a window through which domestic consumers can purchase more foreign goods if prices start to rise at home, and management can export jobs should labor become too intransigent. Third, while the productivity figures are still subpar, the surge in job creation, the heavy reliance on high-technology industries to provide those jobs, and the possibility of higher growth in capital spending all combine to make the gains in productivity look less anemic.

All this might suggest that if the Fed keeps an even hand on the rudder, balanced non-inflation growth could continue for many years. The economy would perform like the 1960's, only better because this time the Federal government, having learned its lesson, would not try to fight the War on Vietnam and the War on Poverty at the same time.

This is certainly a very attractive scenario, but probably unrealistic. For practical purposes, the Fed can use tight money to stop demand-pull inflation without sending the economy into a recession; it can use balanced monetary policy to keep growth increasing at equilibrium rates. However, it can use tight money to stop a cost-push inflation only by causing a recession.

Indeed, the real reason that we generally have higher inflation in the latter stages of business cycle recovery is not really "demand-pull" -- too much money chasing too few goods. We did see some speculative investment during the late 1970's in hard assets, notably housing, precious metals, and other collectibles, and some of this was indeed due to an unfortunate attempt by the Fed to keep the economy moving ahead long after it should have been painfully obvious that double-digit inflation was emerging as the most serious problem facing the American economy. However, even that was an exception, and the idea of inadequate productive capacity has not really occurred since the days of the Korean War.

The true nature of increasing inflation depends more on supply-side factors; sometimes this is referred to as cost-push, but that too implies a rise in the actual cost of the factors of production, particularly wage rates. However, wage rates do not lead inflation, although they generally do an excellent job of following it. Our argument is that the increase in inflation in the latter stages of the cycle is tied more to the decline in productivity, which occurs as follows.

As production rises, it is generally necessary to utilize less efficient plant and equipment that had been mothballed during the recession. In addition, the quality of additional labor hired is often not as high, either because new workers have less training and experience or because they are marginal workers at best; what are commonly referred to as bottom-of-the-barrel workers. Finally, management is often not as keen to monitor costs closely when sales and profits are booming. Hence with all these rising costs of production,

it is not surprising that inflation increases. This pattern continues until the monetary authorities tighten credit, reduce demand, and force businesses to return to more productive methods. This usually causes a recession.

In order for inflation to accelerate, it is necessary for both domestic and international conditions to change. Domestic productivity must start to slide, as indicated above, and the easy access through the international window must be removed. The latter could occur through a decline in the value of the dollar to its former equilibrium level, a noticeable disappearance of excess capacity in the rest of the world, a rescheduling of Third World debt so that the necessity to export would become less intense, a political solution imposed in terms of much higher tariffs and stricter quotas -- or some combination of the above.

Thus so long as foreign competition keeps domestic producers from widening their profit margins, and productivity gains continue to advance for more than strictly cyclical reasons, inflation will stay near its present level of 4%. Some would claim that the economy has enjoyed "good breaks" from lower food and energy prices, but somehow these only seem to occur when inflation is low in the first place; obviously the strength of the dollar and generally lower worldwide inflation affect these commodity prices just as they do unit labor costs. Thus these trends will also continue in tandem with the strong dollar, and inflation will remain in the 4% to 5% range through 1985. If this occurs, we see no roadblocks that would reduce real growth below 4% next year.

TABLE 1.1 - MAJOR ECONOMIC INDICATORS

VARIABLE NAME	1984.2	1984.3	1984.4	1985.1	1985.2	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1984	1985	1986
GROSS NATIONAL PRODUCT	3646.4	3730.5	3815.9	3905.9	3988.9	4069.1	4162.1	4250.0	4341.5	4426.3	4512.6	3686.5	4031.5	4382.6
GROSS NATIONAL PRODUCT, 1972 $	1640.2	1664.5	1687.7	1708.4	1725.7	1739.5	1757.1	1773.3	1789.1	1801.8	1814.8	1650.8	1732.7	1794.8
INDEX OF INDUS PRODUCTION,TOTAL	162.9	165.7	169.2	171.7	173.9	175.6	177.6	179.6	181.8	183.5	185.2	164.4	174.7	182.5
CONSUMPTION EXPENDITURES	2326.7	2381.3	2443.3	2505.8	2559.9	2612.6	2667.8	2728.0	2789.5	2847.6	2904.3	2356.9	2586.5	2817.4
DURABLE GOODS	318.7	333.4	348.3	355.5	361.4	366.6	373.9	381.9	390.6	397.8	403.1	327.8	364.3	393.4
AUTOMOBILES AND PARTS	152.0	159.6	167.1	169.8	172.3	174.3	177.7	181.0	185.3	189.0	189.9	156.6	173.5	186.3
OTHER DURABLE GOODS	166.7	173.8	181.2	185.7	189.1	192.3	196.2	200.9	205.4	208.8	213.2	171.2	190.8	207.1
NONDURABLE GOODS	857.8	872.8	892.9	914.9	934.2	951.6	972.0	996.1	1021.4	1044.9	1066.8	866.2	943.2	1032.3
SERVICES	1150.2	1175.0	1202.1	1235.5	1264.3	1294.4	1322.0	1350.0	1377.4	1405.0	1434.3	1162.9	1279.0	1391.7
NEW CAR SALES, SAAR	10.7	11.0	11.1	11.1	11.1	11.2	11.2	11.2	11.2	11.2	11.2	10.9	11.2	11.2
RETAIL SALES	324.6	330.8	341.9	350.1	356.9	363.1	370.7	379.5	388.7	396.6	404.3	328.3	360.2	392.3
GROSS PRIVATE INVESTMENT	631.5	647.8	655.4	670.5	685.5	699.1	715.8	731.0	747.4	760.6	773.2	639.6	692.7	753.0
FIXED INVESTMENT	577.7	601.0	616.9	628.8	644.8	659.2	675.5	690.6	706.5	718.6	730.5	586.4	652.1	711.6
NONRESIDENTIAL	421.2	441.0	460.1	471.8	486.0	497.5	511.0	523.1	537.7	549.7	562.4	430.3	491.6	543.2
STRUCTURES	152.1	159.5	168.8	174.5	180.5	186.7	193.0	198.5	204.8	211.7	218.2	155.7	183.7	208.3
EQUIPMENT	269.1	281.5	291.2	297.3	305.5	310.9	318.0	324.6	332.8	338.0	344.2	274.6	307.9	334.9
RESIDENTIAL STRUCTURES	156.6	160.0	156.9	157.0	158.8	161.7	164.5	167.4	168.8	168.9	168.1	156.2	160.5	168.3
CHANGE IN INVENTORIES	53.8	46.8	38.5	41.7	40.7	39.9	40.3	40.5	40.9	42.0	42.6	53.2	40.6	41.5
TOTAL PRIVATE HOUSING STARTS	1.91	1.83	1.77	1.80	1.81	1.84	1.85	1.87	1.86	1.82	1.78	1.87	1.82	1.83
NET EXPORTS, GOODS AND SERVICES	-58.0	-61.3	-66.8	-70.6	-72.7	-75.0	-76.5	-79.9	-82.3	-84.7	-86.6	-59.4	-73.7	-83.4
EXPORTS	371.4	381.2	389.4	399.4	410.5	422.4	434.7	445.1	456.1	467.3	478.8	375.2	416.7	461.8
IMPORTS	429.4	442.5	456.2	469.9	483.2	497.4	511.2	525.0	538.4	552.1	565.4	434.6	490.4	545.2
GOVERNMENT PURCHASES	746.1	762.7	784.0	800.1	816.3	832.4	855.0	870.9	886.8	902.8	921.7	749.3	825.9	895.6
FEDERAL	299.3	307.5	320.4	327.6	334.9	342.1	355.8	362.7	369.7	376.7	386.5	298.7	340.1	373.9
NATIONAL DEFENSE	221.3	228.2	238.1	244.1	250.1	256.1	266.7	272.6	278.6	284.6	293.5	225.3	254.2	282.3
OTHER	78.0	79.2	82.3	83.5	84.8	86.0	89.1	90.1	91.1	92.1	93.1	73.4	85.8	91.6
STATE AND LOCAL	446.7	455.2	463.6	472.5	481.4	490.3	499.3	508.2	517.2	526.2	535.2	450.6	485.9	521.7
FEDERAL GOVT SURPLUS OR DEFICIT	-170.3	-167.6	-168.3	-172.8	-171.6	-169.6	-170.2	-180.2	-178.3	-176.2	-175.5	-169.2	-171.0	-177.6
PERSONAL INCOME	2984.8	3047.0	3117.5	3190.9	3261.1	3330.1	3406.5	3480.5	3557.9	3631.9	3711.4	3017.4	3297.2	3595.4
DISPOSABLE PERSONAL INCOME	2557.6	2604.9	2660.0	2728.0	2786.0	2842.7	2903.4	2977.0	3040.7	3101.3	3164.4	2581.2	2815.0	3070.8
CORP PROFITS BEFORE TAXES	240.7	243.0	253.9	266.2	273.8	279.2	294.4	294.0	301.6	302.6	308.7	245.2	278.4	301.7
CORP PROFITS AFTER TAXES	149.0	149.2	159.2	166.8	171.9	175.6	187.1	185.3	190.3	190.9	197.5	152.0	175.3	191.0
CAPACITY UTILIZATION, PCT	80.7	80.5	81.0	81.3	81.6	81.7	82.0	82.1	82.6	82.8	83.0	80.7	81.6	82.6
UNEMPLOYMENT RATE	7.4	6.7	6.2	6.0	5.8	5.7	5.6	5.6	5.6	5.6	5.6	7.0	5.8	5.6
SAVING RATE	6.0	5.6	5.1	5.2	5.1	5.1	5.2	5.4	5.3	5.3	5.3	5.7	5.2	5.3
IMPLICIT GNP DEFLATOR	222.3	224.1	226.1	228.6	231.1	233.9	236.9	239.7	242.7	245.7	248.7	223.3	232.6	244.2
CONSUMER PRICE INDEX	309.7	312.4	315.9	319.8	323.7	327.8	332.0	336.4	341.2	345.9	350.4	311.2	325.8	343.5
PRODUCER PRICE INDEX, TOTAL	311.6	311.8	314.2	317.4	320.3	323.8	327.3	331.1	335.0	338.9	342.9	311.7	322.2	337.0
PRODUCER PRICE INDEX,FINISH GDS	291.4	293.3	295.8	298.6	301.0	304.6	307.8	311.3	314.6	318.4	322.1	292.8	303.0	316.6
PRODUCER PRICE INDEX, IND COMM	323.2	324.1	326.3	329.5	332.4	336.0	339.7	343.7	347.7	352.0	356.2	323.5	334.4	349.9
MONEY SUPPLY, M1	540.8	550.4	560.0	570.8	579.6	587.0	597.5	606.4	616.1	623.8	631.5	546.0	583.7	619.4
MONEY SUPPLY, M2	2258.2	2303.6	2349.7	2398.3	2448.7	2499.7	2553.8	2607.8	2662.4	2717.5	2774.0	2282.8	2475.1	2690.4
FEDERAL FUND RATE	10.56	10.22	9.83	9.90	9.96	9.95	10.00	10.02	10.09	10.11	10.18	10.07	9.95	10.10
TREASURY BILL RATE, 91-DAY	9.80	9.49	9.03	9.02	8.99	8.97	9.04	9.06	9.06	9.06	9.14	9.37	9.01	9.08
COMM PAPER RATE, 4-6 MONTH	10.77	10.70	9.62	9.66	9.68	9.67	9.72	9.74	9.78	9.79	9.86	10.13	9.68	9.79
PRIME COMMERCIAL BANK RATE	12.31	12.89	12.14	11.95	11.94	11.90	11.89	11.88	11.87	11.85	11.85	12.10	11.92	11.86
AAA CORP RATE	13.19	12.88	12.25	12.05	12.20	12.57	12.64	12.63	12.66	12.76	12.93	12.65	12.37	12.75

VARIABLE NAME	1984.2	1984.3	1984.4	1985.1	1985.2	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1984	1985	1986
TABLE 2.1 - MAJOR ECONOMIC INDICATORS, PRODUCT AND INCOME (PERCENT CHANGE, ANNUAL RATES)														
GROSS NATIONAL PRODUCT	10.9	9.5	9.5	9.8	8.8	8.3	9.5	8.7	8.9	8.0	8.0	11.6	9.4	8.7
GROSS NATIONAL PRODUCT, 1972 $	7.5	6.1	5.7	5.0	4.1	3.2	4.1	3.7	3.6	2.9	2.9	7.6	5.0	3.6
INDEX OF INDUS PRODUCTION,TOTAL	8.0	7.1	8.7	6.1	5.3	4.0	4.6	4.5	5.0	3.7	3.7	11.4	6.3	4.5
INDEX OF INDUS PRODUCTION, MFG	8.2	7.1	8.3	6.2	5.1	3.9	4.4	4.4	4.9	3.5	3.6	11.8	6.2	4.3
CONSUMPTION EXPENDITURES	9.1	9.7	10.8	10.6	8.9	8.5	8.7	9.3	9.3	8.6	8.2	9.3	9.7	8.9
DURABLE GOODS	10.4	19.8	19.1	8.5	6.8	5.9	8.2	8.8	9.5	7.5	5.5	17.1	11.1	8.0
AUTOMOBILES AND PARTS	12.2	21.7	19.9	6.7	6.0	4.7	8.0	7.7	9.8	8.3	1.8	21.1	10.8	7.4
OTHER DURABLE GOODS	8.9	18.1	18.3	10.2	7.5	7.1	8.3	9.9	9.2	6.8	8.9	13.8	11.5	8.5
NONDURABLE GOODS	8.1	7.2	9.5	10.2	8.7	7.7	8.8	10.3	10.6	9.5	8.7	8.0	8.9	9.5
SERVICES	9.5	8.9	9.6	11.6	9.7	9.9	8.8	8.8	8.4	8.2	8.6	8.2	10.0	8.8
NEW CAR SALES, SAAR	5.0	12.1	4.6	-1.8	1.6	1.5	2.2	-0.8	0.5	-0.5	-1.1	18.9	2.8	0.5
GROSS PRIVATE INVESTMENT	5.0	10.7	4.8	9.5	9.3	8.1	9.9	8.8	9.3	7.3	6.8	35.6	8.3	8.7
FIXED INVESTMENT	21.7	17.1	11.0	8.0	10.6	9.2	10.3	9.2	9.6	7.0	6.8	20.9	11.2	9.1
NONRESIDENTIAL	24.4	20.2	18.5	10.6	12.6	9.8	11.3	9.8	11.6	9.3	9.6	21.9	14.3	10.5
STRUCTURES	30.9	21.0	25.5	14.2	14.3	14.4	14.2	12.0	13.4	14.2	12.8	20.0	18.0	13.4
EQUIPMENT	20.8	19.7	14.6	8.6	11.6	7.1	9.6	8.5	10.5	6.3	7.6	23.0	12.1	8.8
RESIDENTIAL STRUCTURES	15.1	9.0	-7.6	0.4	4.7	7.3	7.1	7.4	3.4	0.2	-1.8	18.1	2.8	4.9
EXPORTS	14.7	11.0	8.9	10.7	11.6	12.1	12.1	9.9	10.3	10.2	10.2	11.6	11.1	10.8
IMPORTS	19.8	12.7	13.1	12.6	11.8	12.3	11.5	11.3	10.6	10.6	10.0	26.2	12.8	11.2
GOVERNMENT PURCHASES	25.9	9.2	11.7	8.5	8.3	8.2	11.3	7.6	7.5	7.4	8.6	9.3	10.2	8.4
FEDERAL	56.5	11.4	17.9	9.3	9.1	8.9	17.0	8.0	7.9	7.8	10.9	10.7	13.9	9.9
NATIONAL DEFENSE	15.7	13.1	18.4	10.5	10.2	9.9	17.6	9.1	9.1	8.9	13.1	12.3	12.9	11.0
OTHER	328.9	6.5	16.6	6.1	6.0	5.9	15.0	4.6	4.5	4.5	4.4	6.0	16.9	6.7
STATE AND LOCAL	9.4	7.8	7.6	7.9	7.8	7.6	7.5	7.4	7.2	7.1	7.0	8.4	7.8	7.4
PERSONAL INCOME	9.1	8.6	9.6	9.8	9.1	8.7	9.5	9.0	9.2	8.6	9.0	10.0	9.3	9.0
DISPOSABLE PERSONAL INCOME	9.2	7.6	8.7	10.6	8.8	8.4	8.8	10.5	8.8	8.2	8.4	10.3	9.1	9.1
DISPOSABLE PERS INCOME, 1972$	6.9	4.3	5.4	5.5	4.2	3.3	4.1	5.4	3.6	3.1	3.7	7.0	4.8	4.1
CORP PROFITS BEFORE TAXES	-4.2	3.9	19.1	20.7	12.0	8.1	23.7	-0.6	10.8	1.3	8.3	20.7	13.5	8.4
CORP PROFITS AFTER TAXES	-4.2	0.4	29.7	20.6	12.7	9.0	28.7	-3.7	11.3	1.2	14.5	19.3	15.4	8.9
TABLE 2.2 - MAJOR ECONOMIC INDICATORS, PRICE AND MONETARY (PERCENT CHANGE, ANNUAL RATES)														
IMPLICIT GNP DEFLATOR	3.2	3.3	3.6	4.6	4.5	4.9	5.2	4.8	5.1	5.0	5.0	3.7	4.2	5.0
IMPLICIT CONSUMPTION DEFLATOR	2.2	3.1	3.2	4.8	4.4	4.9	4.5	4.9	5.1	4.9	4.6	3.1	4.1	4.8
CONSUMER PRICE INDEX	3.9	3.5	4.5	5.1	4.9	5.2	5.2	5.4	5.9	5.5	5.3	4.3	4.7	5.4
PRODUCER PRICE INDEX, TOTAL	2.9	0.3	3.1	4.1	3.8	4.5	4.4	4.7	4.7	4.8	4.7	2.9	3.4	4.6
PRODUCER PRICE INDEX,FINISH GDS	1.1	2.7	3.4	3.9	3.2	4.9	4.3	4.6	4.4	4.9	4.8	2.7	3.5	4.5
PRODUCER PRICE INDEX, IND COMM	3.4	1.1	2.7	4.0	3.5	4.5	4.4	4.8	4.8	4.9	4.9	2.5	3.3	4.6
MONEY SUPPLY, M1	6.2	7.2	7.2	8.0	6.3	5.2	7.3	6.1	6.5	5.1	5.0	7.2	6.9	6.1
MONEY SUPPLY, M2	7.1	8.3	8.2	8.5	8.7	8.6	8.9	8.7	8.6	8.5	8.6	7.9	8.4	8.7

VARIABLE NAME	1984.2	1984.3	1984.4	1985.1	1985.2	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1984	1985	1986
TABLE 3.1 - GROSS NATIONAL PRODUCT IN CONSTANT DOLLARS														
GROSS NATIONAL PRODUCT	1640.2	1664.5	1687.7	1708.4	1725.7	1739.5	1757.1	1773.3	1789.1	1801.8	1814.8	1650.8	1732.7	1794.8
CONSUMPTION EXPENDITURES	1061.7	1078.1	1097.5	1112.4	1124.2	1133.7	1145.0	1157.0	1168.5	1178.6	1188.7	1070.3	1128.8	1173.2
DURABLE GOODS	177.6	184.2	191.1	194.1	196.0	197.1	199.5	202.2	204.9	206.6	208.3	181.7	196.7	205.5
AUTOMOBILES AND PARTS	77.3	81.0	84.1	85.1	85.9	86.5	87.7	88.9	90.0	90.7	91.2	79.4	86.3	90.2
OTHER	100.3	103.2	107.0	109.0	110.0	110.5	111.8	113.4	114.9	115.9	117.0	102.2	110.3	115.3
NONDURABLE GOODS	396.0	401.4	408.1	413.2	417.9	420.5	424.6	429.6	434.6	439.2	443.0	398.1	419.0	436.6
SERVICES	488.0	492.5	498.3	505.1	510.3	516.2	520.9	525.2	529.0	532.8	537.5	490.5	513.1	531.1
GROSS PRIVATE INVESTMENT	286.2	292.3	294.7	299.4	303.4	306.1	309.9	313.0	316.2	317.9	319.4	289.7	304.7	316.6
FIXED INVESTMENT	264.6	273.3	279.2	282.8	287.3	290.4	294.3	297.4	300.7	302.1	303.6	267.7	288.7	301.0
NONRESIDENTIAL	202.6	210.5	218.1	222.5	227.0	229.8	233.2	236.0	239.4	241.4	243.6	206.1	228.1	240.1
STRUCTURES	57.7	60.2	63.4	65.4	67.1	68.7	70.2	71.4	72.6	73.9	75.0	58.9	67.8	73.2
EQUIPMENT	144.9	150.3	154.7	157.1	159.9	161.1	163.0	164.6	166.8	167.5	168.6	147.3	160.3	166.9
RESIDENTIAL STRUCTURES	62.0	62.8	61.0	60.2	60.2	60.6	61.1	61.5	61.3	60.8	60.0	61.6	60.5	60.9
NONFARM	59.3	60.1	58.3	57.4	57.4	57.7	58.1	58.5	58.3	57.7	56.8	58.9	57.7	57.8
FARM	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
PROD DURABLE EQUIP	2.3	2.3	2.3	2.4	2.4	2.5	2.6	2.6	2.7	2.7	2.8	2.3	2.5	2.7
CHANGE IN INVENTORIES	21.5	19.0	15.5	16.7	16.1	15.7	15.6	15.5	15.5	15.8	15.8	21.9	16.0	15.7
NONFARM	20.4	19.0	15.5	16.7	16.1	15.7	15.6	15.5	15.5	15.8	15.8	20.3	16.0	15.7
FARM	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.6	0.0	0.0
NET EXPORTS, GOODS & SERVICES	-10.0	-12.1	-14.5	-16.1	-17.5	-18.4	-18.9	-19.9	-20.5	-21.3	-21.8	-11.2	-17.7	-20.9
EXPORTS	148.8	151.0	152.3	154.3	156.4	158.8	161.3	163.3	165.3	167.3	169.4	149.2	157.7	166.3
IMPORTS	158.8	163.1	166.8	170.4	173.9	177.2	180.2	183.1	185.8	188.6	191.2	160.5	175.4	187.2
GOVERNMENT PURCHASES	302.4	306.2	310.0	312.7	315.6	318.0	321.1	323.1	324.9	326.6	328.5	302.0	316.9	325.8
FEDERAL	123.7	125.1	127.7	129.3	131.0	132.3	134.3	135.5	136.6	137.6	138.7	122.2	131.7	137.1
STATE AND LOCAL	178.7	181.2	182.3	183.4	184.6	185.8	186.8	187.6	188.3	189.1	189.8	179.9	185.2	188.7
TABLE 3.2 - IMPLICIT PRICE DEFLATORS FOR GNP														
GROSS NATIONAL PRODUCT	222.3	224.1	226.1	228.6	231.1	233.9	236.9	239.7	242.7	245.7	248.7	223.3	232.6	244.2
CONSUMPTION EXPENDITURES	219.2	220.9	222.6	225.3	227.7	230.4	233.0	235.8	238.7	241.6	244.3	220.2	229.1	240.1
DURABLE GOODS	179.4	181.0	182.2	183.1	184.4	186.0	187.4	188.8	190.6	192.5	193.5	180.4	185.2	191.4
NONDURABLE GOODS	216.6	217.5	218.8	221.4	223.5	226.3	228.9	231.9	235.0	237.9	240.8	217.6	225.0	236.4
SERVICES	235.7	238.6	241.3	244.6	247.7	250.8	253.8	257.0	260.4	263.7	266.9	237.0	249.2	262.0
FIXED INVESTMENT	218.3	219.9	221.0	222.4	224.5	227.0	229.5	232.2	234.9	237.9	240.7	218.9	225.8	236.4
NONRESIDENTIAL	207.8	209.5	210.9	212.0	214.1	216.5	219.1	221.7	224.6	227.8	230.9	208.6	215.4	226.2
STRUCTURES	263.5	265.0	266.3	266.9	269.0	271.9	274.9	278.2	282.2	286.5	290.9	264.3	270.7	284.5
EQUIPMENT	185.7	187.2	188.2	189.2	191.0	192.9	195.1	197.2	199.6	201.8	204.1	186.4	192.1	200.7
RESIDENTIAL	252.6	254.8	257.0	260.7	263.7	266.6	269.2	272.3	275.2	278.0	280.4	253.5	265.1	276.5
NONFARM	255.6	257.8	260.2	264.1	267.1	270.2	272.9	276.0	279.1	282.0	284.6	256.5	268.6	280.4
FARM	258.0	260.3	262.5	266.3	269.3	272.3	275.0	278.1	281.1	283.9	286.4	259.8	270.7	282.4
PROD DURABLE EQUIP	174.2	175.7	177.2	179.8	181.8	183.9	185.7	187.8	189.8	191.7	193.4	175.3	182.8	190.7
EXPORTS	249.6	252.4	255.7	258.8	262.4	266.0	269.5	272.6	275.9	279.3	282.7	251.4	264.2	277.6
IMPORTS	270.3	271.3	273.6	275.7	277.9	280.8	283.7	286.7	289.7	292.8	295.8	270.8	279.5	291.2
GOVERNMENT PURCHASES	246.7	249.0	252.9	255.9	258.6	261.7	266.3	269.5	273.0	276.4	280.6	248.0	260.6	274.9
FEDERAL	241.9	245.7	251.0	253.4	255.6	258.6	264.8	267.6	270.7	273.8	278.6	244.3	258.1	272.7
STATE AND LOCAL	250.0	251.3	254.2	257.6	260.8	263.9	267.3	270.9	274.6	278.3	282.0	250.5	262.4	276.5
GOVT OUTPUT ORIG	236.1	239.0	245.2	248.1	250.1	252.8	259.7	262.2	264.7	267.2	272.3	238.4	252.7	266.6

VARIABLE NAME	1984.2	1984.3	1984.4	1985.1	1985.2	1985.3	1985.4	1986.1	1986.2	1986.3	1986.4	1984	1985	1986
TABLE 4.1 - GROSS NATIONAL PRODUCT IN CONSTANT DOLLARS (PERCENT CHANGE, ANNUAL RATES)														
GROSS NATIONAL PRODUCT	7.5	6.1	5.7	5.0	4.1	3.2	4.1	3.7	3.6	2.9	2.9	7.6	5.0	3.6
CONSUMPTION EXPENDITURES	6.9	6.8	7.4	5.5	4.3	3.4	4.0	4.3	4.0	3.5	3.5	6.1	5.5	3.9
DURABLE GOODS	9.3	15.7	15.9	6.4	3.8	2.3	5.0	5.6	5.4	3.4	3.2	15.4	8.3	4.5
AUTOMOBILES AND PARTS	11.6	20.7	16.3	4.8	3.7	2.9	5.6	5.4	5.3	3.2	2.2	19.2	8.7	4.5
OTHER	7.5	12.0	15.6	7.7	3.9	1.8	4.6	5.7	5.5	3.5	4.0	12.6	7.9	4.5
NONDURABLE GOODS	9.5	5.6	6.9	5.1	4.7	2.5	3.9	4.8	4.7	4.3	3.5	5.8	5.2	4.2
SERVICES	3.9	3.7	4.8	5.6	4.2	4.7	3.7	3.4	2.9	2.9	3.5	3.2	4.6	3.5
GROSS PRIVATE INVESTMENT	1.0	8.8	3.3	6.6	5.5	3.6	5.1	4.0	4.2	2.1	1.9	31.1	5.2	3.9
FIXED INVESTMENT	18.0	13.8	8.8	5.3	6.6	4.4	5.4	4.4	4.5	1.9	1.9	19.2	7.8	4.3
NONRESIDENTIAL	20.7	16.6	15.2	8.3	8.4	4.9	6.0	4.9	5.9	3.4	3.8	20.5	10.7	5.2
STRUCTURES	29.4	18.5	23.1	13.1	10.9	9.6	9.3	6.8	7.0	7.5	6.2	19.6	15.3	7.9
EQUIPMENT	17.4	15.8	12.2	6.5	7.3	3.0	4.7	4.0	5.4	1.6	2.7	20.9	8.8	4.1
RESIDENTIAL STRUCTURES	9.6	5.1	-10.7	-5.2	0.1	2.6	3.0	2.6	-0.9	-3.7	-5.2	14.8	-1.7	0.6
NONFARM	9.3	5.4	-11.5	-5.8	-0.2	2.4	2.8	2.4	-1.2	-4.3	-5.8	15.1	-2.1	0.2
EXPORTS	11.2	6.0	3.5	5.4	5.6	6.2	6.3	5.1	5.0	5.0	5.0	7.0	5.7	5.5
IMPORTS	15.4	11.3	9.4	9.1	8.3	7.8	7.0	6.7	6.0	6.0	5.6	26.5	9.3	6.7
GOVERNMENT PURCHASES	19.1	5.2	5.0	3.5	3.7	3.2	3.9	2.5	2.2	2.1	2.3	3.5	4.9	2.8
FEDERAL	47.7	4.7	8.4	5.1	5.5	3.9	6.4	3.5	3.2	2.9	3.4	5.1	7.8	4.1
STATE AND LOCAL	3.2	5.6	2.7	2.4	2.6	2.6	2.1	1.8	1.6	1.6	1.5	2.4	2.9	1.9
TABLE 4.2 - IMPLICIT PRICE DEFLATORS FOR GNP (PERCENT CHANGE, ANNUAL RATES)														
GROSS NATIONAL PRODUCT	3.2	3.3	3.6	4.6	4.5	4.9	5.2	4.8	5.1	5.0	5.0	3.7	4.2	5.0
CONSUMPTION EXPENDITURES	2.2	3.1	3.2	4.8	4.4	4.9	4.5	4.9	5.1	4.9	4.6	3.1	4.1	4.8
DURABLE GOODS	0.9	3.6	2.7	1.9	2.9	3.6	3.0	3.1	3.8	4.0	2.2	1.5	2.7	3.1
NONDURABLE GOODS	-1.5	1.6	2.5	4.9	3.9	5.0	4.7	5.3	5.6	5.0	5.0	2.1	3.4	5.1
SERVICES	5.4	5.0	4.5	5.7	5.2	5.0	4.9	5.2	5.3	5.2	4.9	4.9	5.1	5.1
FIXED INVESTMENT	3.2	3.0	2.0	2.6	3.8	4.5	4.6	4.6	4.9	5.0	4.8	1.4	3.1	4.7
NONRESIDENTIAL	2.9	3.3	2.8	2.1	3.9	4.6	5.0	4.8	5.4	5.7	5.6	1.1	3.3	5.0
STRUCTURES	1.4	2.3	1.9	1.0	3.1	4.4	4.5	4.9	6.0	6.2	6.3	0.3	2.4	5.1
EQUIPMENT	2.8	3.4	2.2	2.0	4.0	4.0	4.7	4.4	4.8	4.6	4.7	1.8	3.0	4.5
RESIDENTIAL	5.2	3.6	3.5	5.9	4.6	4.6	4.0	4.7	4.3	4.1	3.5	2.9	4.6	4.3
NONFARM	5.3	3.5	3.7	6.1	4.7	4.7	4.0	4.7	4.5	4.3	3.7	2.9	4.7	4.4
FARM	-0.8	3.6	3.5	5.9	4.6	4.6	4.0	4.7	4.3	4.1	3.5	5.1	4.2	4.3
EXPORTS	3.1	4.6	5.2	5.0	5.6	5.6	5.5	4.6	5.0	5.0	5.0	4.3	5.1	5.1
IMPORTS	3.6	1.5	3.4	3.2	3.2	4.2	4.2	4.3	4.3	4.3	4.2	-0.2	3.2	4.2
GOVERNMENT PURCHASES	5.7	3.9	6.3	4.8	4.4	4.8	7.1	5.0	5.2	5.2	6.2	5.6	5.1	5.5
FEDERAL	5.8	6.5	8.8	4.0	3.5	4.8	9.9	4.3	4.6	4.7	7.3	5.2	5.7	5.6
STATE AND LOCAL	6.0	2.1	4.8	5.4	5.1	4.9	5.3	5.5	5.6	5.5	5.5	5.8	4.8	5.4
GOVT OUTPUT ORIG	5.2	5.1	10.8	4.7	3.4	4.3	11.4	3.9	3.8	3.9	7.8	7.2	6.0	5.5

Representative WYLIE. Thank you very much, Mr. Evans. I like your optimistic view.

And now we may have an even more optimistic view, I think, from a quick glance of Mr. Fand's testimony. Mr. David Fand, professor, Wayne State University. We would like to hear from you at this point.

STATEMENT OF DAVID I. FAND, PROFESSOR OF ECONOMICS, WAYNE STATE UNIVERSITY, DETROIT, MI

Mr. FAND. Thank you, Mr. Chairman.

I tend to agree with much of what Mike Evans says, but I will go a little further, as I will explain in my testimony.

I think all of us were very excited by the latest report on the GNP. What was even more exciting—of course, the fact that output was growing so robustly was very satisfying—was the inflation news. The real surprise is to explain why we have had such good inflation news. I think the inflation reports clearly surprised everybody. And I would like to talk a little bit about that.

Before I get into that I would like to say that, while the news has been very, very good, there are two kinds of views that are being heard. One, that we may be facing a deflationary debacle because commodity prices are falling and gold prices are falling. And there is another view that we may be facing soon an acceleration of inflation. In my opinion neither of these views conform with the facts. I don't believe we are facing any deflationary debacle, even though gold prices are falling, and I present some evidence in my testimony to show that monetary policy has been quite accommodative.

I also don't believe that we will face any immediate acceleration of inflation. I am going to go into it and explain why.

I think what explains the very exciting news about inflation is the fact that we are now facing a very elastic aggregate supply function. In other words, the supply function that satisfies American demand is now very elastic, and I think the reason it is very elastic comes down to two things.

One, that there is a lot of excess capacity and unemployment throughout the world.

Two, that now the rest of the world, that is, foreigners throughout the world, are very anxious to acquire dollars.

If you take these two things, namely, the willingness, indeed the anxiousness, of foreigners to earn dollars, and the fact that there is a lot of excess capacity and unemployment throughout the world, and you add that capacity onto our capacity, you essentially get a very elastic aggregate supply function.

As a result of this elastic supply function we in the United States now can have more guns, more butter, and less inflation. That's certainly an extraordinary accomplishment, and I think it is essentially due to the fact that we now have, for maybe one of the few times in our history, a very elastic supply function.

The fact that the rest of the world is anxious to earn dollars means that we have a very strong dollar. The very strong dollar in turn has led to a trade deficit, and the trade deficit in turn has led to very low inflation.

Now you might ask, if the real economy is as strong as I am suggesting it is, why are the financial markets not more exuberant? I think that the financial markets are troubled by the fact, as they say, why are interest rates rising if inflation is falling? That question, why are interest rates rising if inflation is falling, implicitly assumes that the only reason interest rates can rise is because there is an increase in the inflation premium.

On the other hand, it is quite possible that we now have an increase in the real rate of interest: that is, the rate of return is much higher now. I think that what we have right now is a very strong investment boom, fueled in large part by the tax cuts on business, and this is causing the real rate of interest to go up, and that is why interest rates are rising. In other words, it is not an inflation premium; it is, rather, a very high rate of return, an increase in the real rate, that is causing interest rates to go up.

One implication of this analysis is that it should not be bad for the stock market: Not all equities should be falling when interest rates rise. In other words, it is not the kind of increase in interest rates that we had, say, from the late 1960's to 1980, where typically it was the result of an increase in inflation.

Another point is, why is the dollar so strong when we have such large trade deficits? I think the estimates now are that the trade deficit is maybe $120 or $130 billion. Why then is the dollar gaining in strength? This, in my opinion, reflects two factors.

One, the rate of return is very high in this country.

Two, the strong defense and foreign policy of the current administration increases confidence of many people all over the world that the dollar is a safe currency, and in fact makes them think that the dollar is in fact better than gold. So you now have a situation where the rest of the world is dumping gold to acquire dollars, whereas a few years ago they were dumping dollars to acquire gold. In my opinion that is related to the defense and foreign policy of the administration.

Moreover, keep in mind that when the dollar has gone up by 45 percent that means that imports are now coming in at a 45 percent discount. We are now importing over $400 billion. That is a tremendous saving that we are now getting as a result of the strong dollar.

The question about monetary policy. I think that on the whole monetary policy has been pretty good. The Federal Reserve has been accommodating this extraordinary expansion, and I don't agree with those who say we're facing a deflationary debacle and that Volcker is somehow killing the recovery. I don't think that any case can be made along those lines. I think the Federal Reserves has had a good policy, and I also think that the policy that Chairman Volcker recommended at last Wednesday's hearing; namely, for a one point lowering in M1 in 1985, seems to me appropriate.

I also would like to mention that in that last 2 months, in May and June, we have added 1,350,000 jobs. This is extraordinary. And I think we now have to be a little concerned to harness this recovery, that is, to keep it in line, and that is why I think Chairman Volcker's recommendation to lower M1 growth in 1985 by 1 percent will be appropriate.

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I think the trick in this recovery has been that we were able to harness world capacity to meet U.S. demand, and to the extent that that is the key to this recovery, and to the extent that there is enough excess capacity and enough unemployment in the rest of the world, this has one very important implication for the length of the recovery. Normally recoveries last 3 years. That's the average. If what I am saying is correct, and I believe it is, I think this recovery could go to 1987, because I think there is enough excess capacity and enough unemployed resources throughout the world that we can keep it up to 1987. I think that is very positive development.

What about the trade deficit? I think the trade deficit has been one of the most important factors that is keeping down our inflation rate. And if we have no other way to meet the extraordinary demands for investments but by utilizing capacity from the rest of the world, I think this is appropriate.

The budget deficit obviously is a problem. I think we would all be much happier if we had a much lower deficit. On the other hand, I don't think the problem is the deficit. I think the problem is that we have excessive spending. So that if we cannot deal with the deficit by dealing with the spending problem, we are not going to solve the problem. In other words, we have two problems right now. We have a deficit, but we have uncontrolled spending, and we somehow have to deal with those problems simultaneously. I would therefore not go along with an increase in taxes if that turns out to be the only way that people think they can deal with the deficit problem.

There are, of course, many other problems that persist even in a spectacular recovery. The strong dollar does cause some problems for some industries, especially those that have wage rates that are not competitive.

Summing up, I would say we have an extraordinarily strong recovery, based in large measure on tax cuts which have stimulated strong investment demand. Because of the policies followed by the administration, foreigners now have much more confidence in the dollar. This has enabled us to harness world capacity to meet our demand. We therefore have strong growth and low inflation. And I think, if we manage policy correctly, we can prolong this recovery to 1987.

Thank you.

[The prepared statement of Mr. Fand follows:]

PREPARED STATEMENT OF DAVID I. FAND

Mr. Chairman and Members of the Committee:

I welcome this opportunity to present my views on the midyear economic outlook. The Commerce Department's June 20 flash estimates for the second quarter were exciting. The estimates that real GNP grew by 5.7% in the second quarter and by 9.7% in the first quarter gave evidence of a very strong recovery. Even more newsworthy were the estimates that the inflation rate in the first quarter was 3.9% and in the second quarter, 2.8%. The June 20 flash estimates were confirmed by the preliminary estimates released July 23 which raised the first quarter real GNP to over 10%, the second quarter to an unbelievable 7 1/2%, and also raised the inflation rates slightly to 4.4% in the first quarter and 3.2% in the second quarter. This is an extraordinary performance, and such robust growth in the real GNP in the fifth, sixth and seventh quarters of the recovery is remarkable.

The vigor of this recovery is noteworthy since many analysts last year were forecasting an anemic recovery. Other analysts were forecasting a consumer-led recovery of short duration that would not be reinforced by capital

spending. And, still other analysts were forecasting an unbalanced recovery. In any event, to have such declining inflation in the face of a sharp increase in real output and employment requires some explanation, especially when we note that in the past 18 months this economy has added almost seven million jobs.

But despite the Commerce Department's reports of robust economic growth and stable-to-declining inflation, two other views about this recovery seem to persist. Some observers think that we are facing a deflationary disaster: they look at the price of gold, silver, copper, other metals, and commodity prices; they see sharply falling prices; and they believe that we are heading for deflation. At the other side of the spectrum are those who look at the very large budget deficits and the fairly high rates of monetary growth and they fear that we are heading for an acceleration of inflation.

Both of these concerns, the deflationist fear as well as the fear that inflation may accelerate, do not appear to conform with the facts. The view that we are heading towards a deflationary debacle, evidenced by the falling of a number of sensitive commodity prices seems inappropriate. It is indeed ironic that our success in keeping inflation down, which in turn has led to a drop in these sensitive prices following substantial cyclical increases, causes some people to conclude that monetary policy has been too tight.

One way to measure monetary policy is to look at the behavior of real M1 and the monetary base in the first 18 months of this recovery. The data presented in Table 1 show that in this recovery real M1 has increased by 7.7% compared to an average of 2.5% for the other five post-Korean recoveries and that the real monetary base has increased by 8.1% compared to an average of 2.6% for the other five post-Korean recoveries. Given this remarkable, robust growth of both M1 and the monetary base in this recovery, it is difficult to maintain that monetary policy may be stifling this recovery and bringing us to a deflationary debacle because some sensitive prices are falling. These prices may be falling because participants in these markets do not expect any increase in inflation.

The articulated concerns about deflation are perhaps a very good indication that we are not likely to see an acceleration of inflation soon. On the contrary, the economy is undergoing very sharp increases in aggregate demand; and what we really need to account for is why we have such remarkable, robust growth in income, output and employment and yet do so well on the inflation front.

To rationalize our remarkably low inflation I am suggesting that we are now living in a world where the aggregate supply function -- the supply curve of output facing U.S. demand -- is relatively elastic. As a consequence, when

aggregate demand increases in the United States, it generates sharply increased output but does not cause rising prices. I should add that some of the capacity that is available for meeting this increased demand in the United States is not domestic capacity but comes from the rest of the world. This augmented U.S. supply provides an aggregate supply function to meet U.S. demand that is relatively elastic. Accelerating demand has led to more output both here and abroad without any increase in inflation.

The strong U.S. dollar also plays a very key role in explaining why we have had so little inflation in the face of such a vigorous recovery. When the dollar increases in value relative to other currencies, it has two very important effects. First, a dollar rising in value implies that the dollar price of imports will be falling. Thus, if the dollar rises by 40% against some currency, it means that the dollar price of imports from that country has fallen by 40%. And to the extent that import prices fall, it makes a direct contribution to keeping U.S. inflation down. Second, many domestic goods are substitutes for imports, and their prices must be competitive with import prices. Accordingly, a strong dollar lowers not only the price of imports but also the price of domestic goods which are substitutes for imports. Moreover, to the extent that a strong dollar keeps price inflation relatively low, it also helps keep

down wage inflation, giving us an environment where both price and wage inflation have been moderate.

The relatively elastic aggregate supply function, augmented by excess capacity and labor in the rest of the world and in conjunction with the strong dollar, is responsible for the very large trade deficit that we now have. What are the conditions that have produced a relatively elastic aggregate supply function and a large trade deficit? And why has the dollar increased in value in the face of such a large deficit? Obviously, a necessary condition for the large trade deficit is that aggregate demand in the U.S. is expanding briskly. But there are two other conditions that are necessary to explain the emergence of an elastic aggregate supply function which brings about simultaneously robust growth, low inflation, a large trade deficit, and a strong dollar.

The first condition is that foreigners are now eager to acquire dollars, in sharp contrast to the previous administration where foreigners were dumping dollars to acquire gold. Now they appear to be dumping gold to acquire dollars. Foreign nationals throughout the world seem very happy to acquire dollars and dollar denominated assets. This condition is necessary for explaining why the rest of the world is using their unused resources to supply

our needs and how the dollar can gain in value while the trade deficit is running at approximately $120 billion. The second important condition is that there is both excess capacity and unemployment in the rest of the world. If there is excess capacity and if there is unemployment, there is the possibility of using this labor and capacity to create more output without raising prices.

These two conditions appear to be necessary for bringing about and maintaining the condition of a relatively elastic aggregate supply function. Given these two conditions, expansionary policies in the U.S. will result in increased output and increased employment while the inflation will remain the same or may even fall slightly.[1]

Under these relatively unique conditions, we in the U.S. can have more guns and more butter and relatively stable inflation. We have, in effect, a condition in which demand creates its own supply -- the inverse of Say's Law. Rapid economic growth with stable inflation is certainly a very exciting development.

And we have had and continue to have a very robust recovery, evidenced by very strong increases in housing,

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[1]I am indebted to Dr. Albert M. Wojnilower for his penetrating and illuminating analysis of these two conditions. See also "The Financial Outlook as of the Summer of 1984," First Boston Corporation, June 21, 1984.

autos, inventories, capital spending and defense expenditures. All sectors of the economy and especially capital spending are growing vigorously. As shown in Table 2, the growth in real GNP for the first six quarters in this recovery is 6.7%, above the average of 5.9% for the post-Korean recoveries. Indeed, this is the best six-quarter rise for any of the six economic recoveries in the past thirty years; and the GNP revisions released on July 23 raise the growth rate for this recovery.

But some questions come to mind. If the real economy is as strong as I suggest, why are the financial markets not more exuberant? Why is the stock market retreating if we are having a vigorous and strong recovery? Why are interest rates rising if inflation is stable or declining? Many people, both in Wall Street and Main Street are troubled by these questions.

They do not understand how interest rates can be rising while inflation rates are stable, implicitly assuming that interest rates rise only because, or primarily because, of the inflation premium. It is true that from the mid-1960s to 1980 market interest rates in general did reflect primarily the movement of inflation. It is not surprising that many bond market practitioners assume that every increase in interest rates is inevitably associated with some increase in inflation. Yet we all realize that even in a world of

stable inflation or, better yet, a world of stable prices, interest rates can rise and indeed would rise when there is an increase in demand for capital. And looking at the U.S economy today, it is not surprising to see interest rates rising since we know that the demand for capital is quite enormous. We know that the real GNP has shown higher growth rates in this recovery than in the other post-war recoveries and all of this is happening at a time when our domestic saving has not kept up with the demand for capital in an economy that has shown remarkable increases in both guns and butter.

I am suggesting that the rise in interest rates may be due to a rise in the real rate of interest rather than the inflation premium. This suggestion has positive implications for the price of some equities though not for the price of bonds. Bond prices are negatively impacted whether interest rates are rising because of inflation premiums or because the real rate of return has gone up. But for some equity prices it should make a difference.[2]

Briefly, if market interest rates are rising because there is an increase in the demand for capital and the real rate of return is rising, this is not a negative factor for all industries. It should be a negative factor for the

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[2]See D. I. Fand, "High Interest Rates and Inflation in the U.S.: Cause or Effect?", Banca Nazionale Del Lavoro Quarterly Review, pp. 39-51, March 1972, for a further analysis of this issue.

older, stagnant industries that show very little technological advance, no increase in investment and poor productivity. But innovative industries where there has been some technological advance and where there is substantial new investment should be doing well. Accordingly, I am suggesting that equities in the innovative and expanding industries with sizable new investments should be doing well while other equities in older, stagnant industries with very little investment should be doing fairly poorly.

But why is the dollar gaining strength in the face of record trade deficits currently estimated at approximately $120 billion? Why is the rest of the world currently selling gold and other metals and acquiring dollars? And why was the rest of the world selling dollars and acquiring gold and other metals in the previous administration? To begin with, I think the rate of return on dollar assets is very good, and this is certainly a necessary condition. In addition, our strong defense program may raise the real rate of interest and may be another factor which keeps the dollar strong.[3] Confidence in the U.S. as a safe haven has increased. This latter may be thought of as a sufficient condition. And the strong dollar plays a major role in keeping inflation rates down and also enables us to import over $400 billion dollars worth of imports at bargain prices.

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[3]See R. J. Barro, "Output Effects of Government Purchases Journal of Political Economy, pp. 1086-1121, 1981.

A strong dollar which has increased in value by 40% implies that we are obtaining a 40% discount on our imports.

Summing up, the dollar is strong basically for two reasons. First, the rate of return is relatively high, and it is a real rate of interest and not just an inflation premium. Second, the defense and foreign affairs policies of this administration have increased confidence in the rest of the world that the dollar is a safe currency and indeed may be better than gold.

The coexistence of a $120 billion trade deficit simultaneously with a strong dollar means that people all over the world are pleased with what they see as American defense and foreign affairs policies, and they are voting for these policies with their choice of dollar assets. A strong defense brings about a strong dollar, which in turn brings low cost imports and low inflation.[4]

What implications does this analysis have for monetary policy? We are fortunate now that our robust demand for goods is being met not only by domestic supplies but also by excess capacity elsewhere in the world which is being made available to us. I believe that one can make a case

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[4]This may partially account for the following paradox. A conservative Republican like President Reagan follows expansionary policies and seems to obtain all the benefits promised by the early textbook Keynesianism. In contrast, when President Carter sought to follow expansionary policies, he ended up with double digit inflation.

for some lowering of the monetary growth rate. Specifically, it may be desirable to lower the upper range of the M1 target by one to two points for 1985.

Chairman Paul Volcker, in reviewing the semi-annual report of the Federal Reserve Board to the Congress, states that "the Federal Open Market Committee (FOMC) reaffirmed the target and monitoring ranges for the various monetary and credit aggregates for 1984 and decided to reduce the top end of the range for M1 and M2 for 1984 and 1985." (See Table 3.) The reasons may be rationalized as follows: If we assume that real GNP may increase by 3% to 4% from 1984(4) to 1985(4) and if we assume a range for the GNP deflator of about 5% to 5 1/2%, it may be appropriate to lower M1 growth to about 6% for this period. There is also the possibility of some increase in velocity as we proceed in this recovery.

While we have been very fortunate with the inflation, the inflation dragon has been weakened but not slain and it can easily recover. We should take advantage of our wonderful situation now and buy additional inflation insurance. For these reasons I would recommend a 1% to 2% lowering in the upper range of the M1 growth rate. The FOMC recommendations are shown in Table 3.

I also believe that we are getting closer to the full utilization of resources in this country and that we have to be a little more concerned not to step over the line.

Were it not for the excess capacity and the unemployed abroad, we could now be facing a serious acceleration of inflation. Again, I wish to stress that the $120 billion of trade deficit and the over $400 billion of imports coming in at rock bottom prices serve as a very powerful brake in keeping down the inflation.

We are all delighted and enthused to learn that over 800,000 jobs were added in May and almost 500,000 jobs in June -- a total of over 1,350,000 jobs for the two month period. This is certainly very gratifying, and it is an exciting piece ofnews to learn that the American economy is still capable of adding that many jobs at this stage of the recovery. On the other hand, one has to worry whether the news is too good and whether we are exceeding safe speed limits for this recovery. It would be better to expand at a more sustainable rate, while still utilizing the excess capacity and unemployment in the rest of the world to meet some of our demands. A lowering of the upper range of the M1 target seems appropriate.

Our ability to harness world capacity to satisfy the buoyant aggregate demand in the U.S. has implications for the length of the recovery.[5] A recovery, on the average,

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[5]I am indebted to Dr. Albert M. Wojnilower for clarification of this issue.

lasts 3 or 3 1/2 years. Accordingly, the recovery which began in November 1982 would be maturing some time at the end of 1985. But if we can continue to harness excess world capacity and unemployed world labor to help meet our growing domestic demands, the recovery could last through 1986 or possibly even 1987. Thus, if we are able to contain and nurture the recovery, we may be able to stretch it out for an extra year or two, and this would be highly desirable for us in the U.S. and for the rest of the world.

Are there any lurking dangers if foreigners keep accumulating dollar assets? At the present time foreigners' willingness to accumulate dollar assets is helping us to meet the very strong demands in our economy. We would not be able to have more guns and more butter if we were not able to get additional output from the rest of the world. One could argue that it would be better if we did not need these resources that we are getting from abroad. That is, it would be better if we were able to do the many things we are now doing with our own resources. But this is not the case. As a consequence, given the U.S. demand for capital and given our savings rate, utilizing the savings from abroad is not a bad solution to our problem.

Another potential danger arises from the size of the budget deficit and its implications. It certainly would be highly desirable not to have any deficit, or to reduce the

one we have. But as the data in Table 2 indicate, we now have one of the strongest recoveries since World War II due in part to the beneficial effects of the tax cuts. We must also keep in mind that while a deficit and the burden it places on the future is undesirable and creates some distortions, raising taxes creates other distortions and may not really succeed in wiping out the deficit. Moreover, while a deficit deprives the private sector of savings that could be used for capital formation, an increase in taxes would also, very likely, wipe out these savings.

If we take the level of government expenditures as given, we cannot select a specific combination of taxes and debt finance and say it is optimal. To minimize the cost of the distortions caused by both taxes and deficits, we must compare the burden of debt financing with the costs of the specific taxes which are to be levied. It does not follow that by reducing the deficit we will necessarily lower interest rates. This will depend on what will be done to reduce spending and how we increase revenues and is not just a function of the size of the deficit. Raising taxes to reduce the deficit may hurt incentives, create distortions, impede the recovery, and create other problems as bad as those due to the deficit.[6]

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[6]For a cogent and clearly articulated analysis, see David I. Meiselman, "Fiscal Policy and Interest Rates," Tax Review, May 1982.

We now have one of the strongest recoveries since World War II, due in part to beneficial effects of the tax cuts. Accordingly, I would like to see more done in cutting expenditures to solve the deficit. If that cannot be done, I would go along with the status quo and hope that there would develop more of a consensus to deal with the deficit, but not by just raising taxes.

There are, of course, some problems, as is to be expected in any period of recovery. Some of our industries, such as steel, are operating below their previous levels. Demand for agricultural products has been stagnant and many farmers are being squeezed by rising interest rates and falling land prices. Personal savings relative to income is low, and we are relying more on foreign capital to meet our needs. Some export industries are damaged, as are some industries that compete with imports, and they seek protectionist relief. The high level of interest has aggravated many financial problems for the farm sector and for many of our thrift institutions. Accordingly, if we can reduce budget deficits and do so without raising taxes this could help reduce some of these strains.

In conclusion, I would like to summarize some unique aspects about the present recovery. The analysis presented here suggests that we are living in a world with the following characteristics:

(1) Europeans, Asians and the rest of the world are willing -- indeed, anxious -- to acquire dollar assets;

(2) The rest of the world has excess capacity and a lot of unemployment;

(3) The U.S. demand has been very robust and this demand has been met by U.S. supply augmented, in part, by world supply; and

(4) Expansionist policies in the U.S. -- large budget deficits and high rates of money growth -- have led to more output and more employment with stable to declining inflation.

In other words, we are in that happy state where expansionist policies are indeed very productive and do not cause inflation. Indeed, we seem to be in a world that appears to be Keynesian -- where, unlike Say's Law, demand creates its own supply and where expansionist policies are productive -- leading to more output and employment and not to more inflation.

It is therefore ironic that at the relatively unique moment in history when expansionist policies seem to be productive, many of our expansionists have become born again budget balancers and seem to be overly concerned with the deficit. I find it strange that at the very moment

when large budget deficits, in conjunction with other policies, have given us extraordinarily fine results in the real economy, so many of our Liberals are worried about the deficit and concerned about trying to do something about the deficit. Since almost 7 million jobs have been added in the last year and a half and since we are operating with a low inflation rate, it would suggest that on purely macro-economic grounds the recovery is quite robust. This concern with the deficit by those who normally favor expansionist policies must therefore reflect, I presume, the non-mac-o-economic items on the Liberals' agenda.

TABLE 1

Growth in Real M1 and the
Monetary Base in the
First Eighteen Months of the
Post-Korean War Expansions

Dates	(1) Real M1	(2) Real MB
5/54 - 11/55	4.0	1.5
4/58 - 10/59	2.7	1.2
2/61 - 8/62	2.0	2.5
11/70 - 5/72	5.0	6.1
3/75 - 9/76	-1.0	1.7
Average	2.5	2.6
11/82 - 5/84(e)	7.7	8.1

Source: Lacy H. Hunt, CM&M Economic Commentary, June 1, 1984.

TABLE 2
Growth in Real GNP in the First Six Quarters
of Post-Korean War Recoveries
(adjusted to an annual rate of change)

Recovery Quarters	Percent Change
1954.II - 1955.IV	6.6
1958.II - 1959.IV	5.7
1961.I - 1963.III	6.0
1970.IV - 1972.II	5.7
1975.I - 1976.III	5.3
Average	5.9
1982.IV - 1984.II	6.7

Source: Lacy H. Hunt, CM&M Commentary, June 22, 1984.

TABLE 3
GROWTH RANGES FOR MONEY AND DEBT FOR 1984,
TENTATIVE GROWTH RANGES FOR 1985,
AND ACTUAL GROWTH THROUGH JUNE 1984

	Ranges 1984	Tentative Ranges 1985	Actual Growth 1983(4) to June
M1	4 to 8	4 to 7	7.5
M2	6 to 9	6 to 8 1/2	7.0
M3	6 to 9	6 to 9	9.7
Debt	8 to 11	8 to 11	13.1

Source: Paul A. Volcker, Statement to U.S. Senate Committee on Banking, Housing and Urban Affairs, July 25, 1984.

Representative WYLIE. Thank you very much, Mr. Fand. That may be the best news I've heard. I liked it.

We will next hear from Mr. Alan Greenspan. I don't pretend to characterize your testimony. I didn't get it quite as early as some of the others.

Anyhow, we will hear from Mr. Alan Greenspan, President and Chairman of Townsend-Greenspan & Co., Inc.

Mr. Greenspan, you may proceed in your own manner.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN AND PRESIDENT, TOWNSEND-GREENSPAN & CO., INC., NEW YORK, NY

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I must say that I have appeared before this committee on numerous occasions over a very long period of time and I don't recall three reputable, very effective, experienced economists looking at the same set of data and indicating as wide a range of differences that has occurred this morning.

Representative WYLIE. It's a matter of degree, maybe.

Mr. GREENSPAN. Well, what it suggests to me is that it is a really quite uncertain outlook in that there is so much in the way of churning within the underlying set of information that it is very difficult to get it stabilized, and sense where the economy will be beyond the very short term. Whenever I get to a point where I think I know exactly what is happening I always remember what my late partner once said about economists: "Often wrong, but never in doubt."

My concern is that we should be very careful to recognize that there is an extraordinary degree of instability in our system, both positive and negative, and that as a consequence the range of forecasts will continue very wide, and the risk of any forecast, I think, will continue to be quite high.

Certainly the data currently reflects a fairly solid, sustained outlook. It is certainly the case, however, that the rate of growth is simmering down. It is probably in the area of 5 percent annual rate in the third quarter. But remember, there is a technical problem in the third quarter data, reflecting the seasonal adjustment of automobile inventories and production which could bias that number upward, as in fact it probably biased the second quarter downward.

As best I can judge there is very little in this economy which one can see immediately that suggests a recession is imminent within the next 6 months to 9 months. In order to project a recession or eventual ending of this really quite extraordinary expansion, we have to look at potential events coming from outside the normal structure of domestic demand, supplies of credit, and the like.

Those of us who put together these forecasts are also acutely aware that if you do not increase interest rates from current levels it is very difficult to turn this economy down. What we therefore could conclude is that a necessary condition for a significant decline in activity is that interest rates rise appreciably.

Here I would disagree somewhat with Larry Chimerine on the question of domestic credit demands, excluding credit for mergers, acquisitions and leverage buyouts. I think that the actual flow of

demand in the context of the nominal GNPs that we are projecting is actually not consistent with a significant rise in interest rates. I think that it is also unlikely that we are looking at any major decline. I must admit I would like to believe Mike Evans on this question, but I am less than convinced.

The problems that we have in the interest rate area, which I consider crucial to the outlook beyond the end of this year, reflects the obvious budget problems. Here I think that what the Congress and the administration does after this election is very critical to long-term inflation premiums.

I must say I disagree with the concept that Mr. Fand has interjected, namely that real interest rates in the long end of the market have gone up. The evidence of that is lacking. Without going into a technical discussion, I would say that even if it has, it is very small relative to the rise in nominal long-term interest rates. That still leaves a very substantial inflation premium embodied in rates, which I would interpret as one reflecting a continued belief by the international financial community that our fiscal processes are still out of control, and that while no individual budget forecast or deficit is crucial, it is the fact that the markets presume that the process is breaking down. Over the very long run the huge costs of interest mounting from the deficits themselves will project the aggregate deficit significantly higher and create pressures on the Fed to accommodate very large treasury borrowing. This in turn would create a rise in money supply, which would generate a major acceleration in the price level, not over the next year or so, but over the next 10, 15 years, which is the timeframe which long-term bonds reflect. It is the embodied inflation premium through the full maturity of the debt instrument.

Second, I think there is a concern that the overall international banking problems will create a type of breakdown which will induce Federal Reserve intervention at a very substantial level, creating huge amounts of reserves, and, again, an excessive inflation-ridden rise in the money supply.

Here the argument, as far as the markets are concerned, is that the LDC debt problem is not one that is resolvable by rescheduling, because rescheduling presupposes that the issue is strictly illiquidity problems. That means that the asset and liability structure of LDC borrowers, is capable of being jiggled in a form which will restore balance.

The evidence suggests that we cannot resolve this problem strictly by rescheduling, and that there is some element of insolvency attached to the debt question. What that means is that the markets presume that there will not be significant new commercial credits going to the LDC's, that the World Bank and IMF are unlikely to create adequate resources, and that direct investment is not something which is going to be sufficiently large to make a difference. In effect, it is the internal savings and investment of the developing countries which are going to have to be expanded to meet the debt service charges on external liabilities. That obviously raises major political as well as economic problems from which the markets infer that those debts will not be fully repaid. That is reflected in the stock prices of various different bank stocks. The stock

prices indicate that it is appropriate to mark those loans down more than is currently on the books.

In the event that we have a significant debt problem and a potential fear of some form of ultimate breakdown, one would expect that long-term inflation premiums will hold up, as I expect that they will hold, although I would be surprised if they rose very much further. If, however, the Congress and the administration can find a way to credibly bring down the long-term deficit in a context in which the markets believe it will be declining for a long period of time, then I think we have the possibility of a very significant decline in long-term interest rates and a rejuvenation of the recovery which will start to stutter a bit next year.

The major short-term problem, that is, over the next year, is the probability that this rise in the U.S. dollar will peak out and start down, and should that occur, as I think it will, because we are running into a glut of dollars held in internationally mobile portfolios, then upward pressure on short-term interest rates is likely, at least for a short while. If we are in a situation in which the dollar begins to glut in the international markets, then you begin to get a desire to reduce investments in the United States. Currently investment flows are unquestionably very strong because of a sense of safe havenness here as well as the large differential of short-term dollar interest rates relative to interest rates in currencies.

Even granting that neither of those change, merely glutting the portfolios will drive the dollar down and induce an endeavor to pull funds out of the United States. But because we have to finance the short-term current account deficit, which will only decrease slightly and slowly as the exchange rate falls, it means that short-term interest rates in the United States must rise in order to hold the rate of fund flows at near current levels.

So what we have as a threat to the interest rate structure is not something that I see basically the result of internal credit demands, but those resulting from external factors, largely fiscal policy actions by the Congress and the President and the problems in the international markets.

I would like to give you an estimate which says that the odds are 60/40 or 62/38 that something will happen one way or the other. The truth of the matter is that our tools are not sufficiently calibrated to enable us to know exactly what the probabilities of any of these happening are.

In any event, the markets at the moment are suggesting that they don't believe anything severe is going to happen in the international sphere nor anything is going to happen to significantly reduce the long-term deficits. I suspect they are wrong in the latter and maybe slightly too optimistic on the former.

Thank you.

[The prepared statement of Mr. Greenspan follows:]

PREPARED STATEMENT OF ALAN GREENSPAN

.....

Economic growth is clearly slowing down. Real growth in the current quarter looks to be in the area of 4-1/2% to 5-1/2% at a seasonally adjusted annual rate versus 7-1/2% in the second quarter and 10% in the first. The frenetic pace of inventory accumulation in the first half of the year appears to be ebbing, orders for basic materials are softening, and some of the over exuberance of the first half definitely seems to have faded. Nonetheless, currently there do not appear to be significant imbalances in the economy which suggest imminent recession. In fact, if we were looking solely at the composition of physical output and its supply and demand, one would be hard pressed to project the beginnings of a recession during the next year.

If the current pattern of short-term economic indicators does not suggest an imminent recession, is there anything outside the conventional balance of economic forces which could trigger a downturn? With profitability still in reasonably good shape, it appears that only a major increase in interest rates could choke off the underlying momentum in the capital goods markets, creating a significant backing up of inventories. Even from current relatively low stock levels, inventory investment could shift from accumulation to liquidation in a relatively short period of time. The major threat of interest rate escalation stems less from the emergence of a massive volume of short-term credit demands than from a potentially significant reduction in the planned flow of capital investment into the United States by foreigners. This could create a reduction in the supply of funds to the United States, at any given level of interest rates. If the investment flow declines, interest rates must rise sufficiently to induce foreigners to maintain their rate of fund flow into the United States if our current account deficit is to be financed. Interest rates would rise to the level required to rebalance the overall supply and demand for funds in the United States. The Federal Reserve, of course, could supply reserves adequate to offset the foreign shortfall, but the inflationary implications could, with a time lag, raise inflation premiums embodied in interest rates, nullifying the Fed's intent.

The relevant capital flow is related to the current account deficits, financing of which currently is running at approximately $80 billion annual rate. This is a staggering sum when we consider that as recently as the first half of 1982 our current account was in surplus. It is fairly obvious, therefore, that were it not for the very sub-

stantial quantities of investment which have been forthcoming from abroad, interest rates in recent years would have been significantly higher than they were.

This leaves us vulnerable to two potentially unsettling developments. First, we could face a dramatic fall in the dollar in the exchange markets, precipitated by a glut in international currency portfolios. Second, we might experience major withdrawals of short-term funds from American banks, either here or at their branches abroad. In the latter case, a net outflow of funds from parent U.S. banks to their foreign branches would be required to finance the asset side of the foreign branches' portfolio. That would reduce the funds available to the domestic market in the same manner as a decline in foreign deposits in domestic banks.

Although we have no conclusive means of determination, the dollar currently is almost surely significantly above its average purchasing power parity relative to all other major currencies.

Since exchange rates clear the market in the short run, the elevated dollar exchange rate must result from demand for dollars to purchase items other than goods and services, mainly financial securities. The flow of foreign capital into the United States to purchase dollar-denominated investments has been large and is, in fact, the mirror image of the current account deficit. Movements into the dollar have also been substantial in the Eurocurrency market, and central banks have also tilted their reserves more toward dollars. Clearly, the continuation of high real dollar-denominated rates of interest relative to those of other currencies has been a major factor in drawing funds into the dollar. The dollar also has been a major attractor of funds seeking a "safe haven."

There is one compelling theoretical argument for a lower dollar eventually. Clearly, the net demand for dollars results mainly from a shift in the mix of portfolios of dollar and other currency holdings of multinational corporations, governments, individuals, banks, and other institutions. In order to maintain a specific premium of the dollar exchange rate over its purchasing power parity, the net flow of funds into the dollar requires a continuing shift from other currencies. If the net portfolio shift evaporates, the demand for dollars would fall. The exchange rate of the dollar presumably would then fall back toward its purchasing power parity value. Consider the case of a desired increase in dollar holding at the expense of Deutsche marks. As the dollar share of the sum of dollars and marks in a hypothetical portfolio rises from say 70% to 75% and then to 80%, one can presume that the exchange rate premium over the purchasing power parity value remains relatively stable. What happens when the shares reach 100% dollars and 0% marks? Barring short selling of marks, no further purchases of dollars will come from this source, even though the portfolio manager still believes incremental dollar investments are superior to mark investments. If we generalize this proposition, a situation is quite conceivable in which the inflation adjusted rate of interest in dollars remains higher than any other currency, "safe

haven" remains a persistent desire, but opportunities for dollar portfolio additions have been exhausted. The net demand shift into dollars would then cease and the exchange rate would fall back toward purchasing power parity.

This example is oversimplified, but nonetheless bears considerable relevance. At some point, portfolio adjustments on a world-wide basis will slacken as all natural limits are achieved. Potential dollar purchasers disappear even though the incentives to hold dollars, owing to high real interest rates and "safe haven" propensities, remain.

Any weakening in the dollar, reflecting saturation of dollar holdings in internationally mobile currency portfolios, will exert pressure to sharply reduce the net inflow of dollars into the United States. However, the actual decline in the rate of inflow of capital into the United States is limited by the rate at which the current account deficit improves. (The capital account surplus must equal the current account balance with sign reversed.; i.e., the balance of payments accounts must balance.) However, the current account deficit will adjust to the fall in the dollar only with a significant lag. Eventually, exports will rise and imports will fall, but this will take time.

The only recourse in the interim is to allow interest rates on dollar-denominated securities to rise until foreigners again become willing holders of dollars in sufficient volume to finance the slowly shrinking current account deficit.

The extent of the rise in interest rates needed to maintain the required capital account surplus during the transition toward balance on the current account will depend, in part, on the rapidity of the decline in the dollar. It is not possible to determine whether the impact on short-term interest rates will be modest, such as 1%, or more severe, conceivably as much as 3%.

Such upward pressure on short-term rates due to international adjustments is essentially a temporary phenomenon. It will be reversed when the current account deficit finally adjusts to the new lower level of the dollar in foreign exchange markets. This is not likely to occur until at least six to nine months after the dollar stabilizes.

The potential threat of a major withdrawal of deposits from American banks derives from the continuing concern over the status of Latin American loans, and the experience of the Continental Illinois National Bank. A run on a bank is very difficult to forecast, even though in retrospect its causes are rarely disguised. The basic problem is that a substantial part, in some cases in excess of 100%, of bank net worth is committed to loans to troubled Latin American countries. This may be exagerated since some of the general reserves of banks are internally perceived as applying against some of the Latin American loans, in effect, unofficially writing them off in part.

The problem is not essentially one of borrower illiquidity. If it were strictly a liquidity issue, it could be appropriately addressed through rescheduling. The definition of illiquidity is a missmatching of the assets and liabilities in the context of positive net worth. However, heavy and fairly effective rescheduling of LDC loans has not stemmed the concern of investors. The market price of the larger banks are selling at deep discounts to book value. Since in better times bank stocks would sell above book, the market is assuming a significant markdown in currently reported book assets. That is, the stock market is making its own chargeoffs, so to speak, over and above those taken in the normal process of reporting bank earnings.

It is clear that the market is concerned about the potential insolvency of Latin American borrowers. To the extent that one can extract the asset and liabilities on foreign account in meaningful way, it's fairly apparent that the total external debt exceeds, by a substantial amount the level of assets produced as a consequence of that debt. I am not referring to actual assets which were held abroad, but rather the assets which were produced as a consequence of the borrowing. It is these assets to which lenders presumably have looked for the generation of earnings adequate to meet the debt service requirements of the associated loans. Since the major expansion in loans following the first oil shock in 1973-1974, a substantial part of subsequent external borrowing from commercial banks has financed consumption. In addition, a substantial part has gone to finance capital investments whose returns are inadequate to fully meet the debt service requirements of their associated loans. Some loans went for productive assets which, unfortunately, have not been able to earn adequate returns owing to the deficient levels of economic activity in the relevant countries. Not surprisingly, the cumulative financial erosion has led to a flight of capital from the debt burdened LDCs. As measured by the "errors and omissions" components of the balance of payments, this amounted to 35% of net external borrowing from private sources during the past three years.

After a number of years of major increases in Eurocurrency loans to developing countries (approximately 25% a year through the latter part of the nineteen seventies), the positive net financial flow turned sharply negative in the last year or so ;the transfer back of resources to the commercial banks in repayment of loans and interest now exceeds net new funds. The ability of Latin American debtors and others to continue to repay their current debt obligations would require a large increase in direct investment, a net new source of borrowing (from the IMF, World Bank, commercial banks and private companies) and/or the generation of internal savings and investment which could be dedicated to payment on foreign account. The market clearly doubts that any of these alternatives will be sufficiently forthcoming to put current loans on a viable basis. Hence the overhanging threat of potential runs on banks.

Representative WYLIE. Thank you very much, Mr. Greenspan.

I have maintained that if you put five economists in the room you will get five different views, and I think that is sort of being borne out here this morning.

Mr. GREENSPAN. May I suggest that that's the minimum.

Representative WYLIE. A minimum number of views.

Mr. Ratajczak has a little different view and degree of optimism. We will hear now from Mr. Donald Ratajczak, director, Economic Forecasting Project, Georgia State University.

Thank you very much, Mr. Ratajczak, for appearing this morning. We appreciate your testimony.

STATEMENT OF DONALD RATAJCZAK, DIRECTOR, ECONOMIC FORECASTING PROJECT, GEORGIA STATE UNIVERSITY, ATLANTA, GA

Mr. RATAJCZAK. Thank you for asking me to testify, Mr. Chairman.

I am afraid I am going to follow the dictum and be slightly different from the other economists, and I apologize for that. We do have a certain point of view that we develop in terms of economic imbalances, inflationary conditions, and while some of our views are supportive of some of the statements that have been made, they are also in conflict with some others.

First of all, let me give you a brief summary of some of the events we are looking at and then I will go into some detail.

First of all, we are expecting that four quarters of 1984 will see real growth of 6.3 percent. This is a little bit misleading because we think it prudent to anticipate that there will be some strike disruptions of industrial production in the fourth quarter. We have placed that in our forecast and have, as a result, removed 1.5 percentage points of growth from the fourth quarter of 1984, recapturing 1 percentage point in the first quarter of 1985.

The four quarters of 1985 we expect to have 3.1 percent real growth. This is relatively consistent with the forecast currently being used by the Federal Reserve. That is purely by accident.

The inflation estimates: We are looking for 4 percent growth in the GNP deflator for the four quarters of this year, accelerating to 5.1 percent growth in 1985.

The reason for the acceleration I will go into some detail later on, but fundamentally we feel that there have been some structural developments occurring to fundamentally lower the underlying inflationary pressures in the United States. However, we also believe that there are some special factors, and those special factors at some point will diminish or in fact be reversed, and as a result we have lower inflation rates today than we have any right to anticipate in the next 2 years.

I share slightly Mr. Chimerine's concerns about where we are in the state of the cycle in terms of borrowing needs. We do anticipate that corporate borrowings will intensify in the latter part of 1984 as a result of the current bond market rally, which I do believe is temporary. However, we do think that this intensifying of corporate borrowing, which is coinciding, unfortunately, with significant Government borrowings as well, will not be of long duration, that

there will be another reversal, and that indeed by the end of 1985 some of the longer, more favorable components leading to significantly lower interest rates will then be in place.

Very quickly, we currently do not see any major economic imbalances in the economy on a cyclical basis. Again, apart from those two issues: The Government deficit and the trade deficit. In fact, the personal savings rate at 6.0 percent in the second quarter is right on the long-term, postwar average savings rate. There is no evidence, for instance, that consumers are being stretched, as in 1979, when the savings rate fell to an unusually low 4.6 percent.

Thus, the current rapid rate of consumer spending can be sustained. The reason why consumer spending has been so effective in generating jobs has been the fact that inflation rates have been low, so that what would be considered relatively moderate growth rates in nominal spending have been converted into relatively significant growth rates in real economic activity. As inflation rates accelerate, this growth in economic activity will diminish somewhat.

However, our feeling is basically that the consumer has been aware of the favorable pricing patterns, has taken advantage of them, and indeed probably will become resistant to significant price increases in 1985. Instead of having the consumer being strained by rising prices, we anticipate the consumer backing off from its buying binge, sort of holding back on spending, and as a result, putting a ceiling on price increases.

Just as an example, in the last four quarters, in real terms, apparel has grown at 14.5 percent. This is three times the long-term growth rate. The last quarter alone food consumption, primarily as a result of a significant increase in customers going to fast food and other outlets, has increased by 8 percent at annual rates. This clearly is unsustainable.

We appropriately believe that the consumer will slow down, but that should not be a case for any dramatic concern.

In the investment sphere, while the first quarter inventory accumulations were somewhat high and certainly could not be sustained at that rate, they were justified because inventory accumulations were unusually low in 1983. They simply could not be sustained at the first quarter rates. However, accumulations in the second quarter have moderated, and we feel that there is no further significant slowing in production for inventory purposes necessary, at least until this consumer slowing occurs.

We are a little bit concerned about little areas, such as rental properties. We think that there are some excesses developing there, and we are also looking closely at what is happening to commercial office building. There is some evidence that office building contract per square footage is exceeding current absorption rates by a relatively significant amount.

Again, we do not feel that these buildups are excessive at the present time, but something that we might have to worry about toward the end of 1985.

In summary, then, when you look at the cyclical components, there is nothing suggesting that there are excesses requiring any significant correction. There are only moderate areas of excesses.

It is kind of interesting that we are talking about commercial building and we are talking about rental property, two interest-sensitive parts of the economy, and yet there seems to be a continuing feeling that the current interest rates are creating a distortion in the current economy's growth. If interest rates are distorting the current economy's growth and presumably slowing the interest-sensitive components of the economy, given the fact that we are seeing moderate excesses in some areas, that is all to the good. Some distortions are favorable. It appears at the present time that current interest rates are not creating the type of distortions that would slow the overall economy.

Now the longer term issues. First of all, the Government deficit has to be a concern if we are right about credit market pressure, that interest rates, therefore, are higher than they otherwise would be because of the volume of Government borrowings. Even yesterday, if you looked at the Government bond market, they had favorable economic statistics, moving a significant bond market rally that abruptly stopped at the announcement of the treasury borrowings for this quarter. The evidence seems to be overwhelming that every time the Federal Government moves into the bond market to engage in significant offerings that it becomes very difficult to sustain any bond market rally. That, at least to me, regardless of all the statistical evidence that is being developed elsewhere, strongly suggests that deficits are having an adverse effect on prevailing interest rates.

Nevertheless, given the fact that in 1985 I do anticipate a somewhat slower growth in the economy, I also think that, at least in current terms, some measures of real interest rates will be beginning to decline; that 1985 probably is not the year that significant deficit reductions should be pursued.

I do not anticipate a recession in 1985, but an aggressive program of reducing deficits at that time, which would probably have its economic impact in 1986, may be very cyclically inappropriate. The structural deficit—unfortunately, the last best time to address it in this cycle is passing us by at the present time. Even though I do not believe we can grown our way out of the deficit problem, I think a significant addressing of that deficit would be appropriately postponed at the present time.

Now to the trade situation.

First, what has the strong dollar done? According to an estimate of trade weighted values of the dollar, the dollar is up approximately 25 percent from an 1980–82 base at the present time. We estimate on that trade weighted basis that that 25-percent improvement in the value of the dollar ultimately will have an impact of lowering the underlying price structure of the United States by 5 percent. Most of that 5-percent reduction in the price structure from what otherwise would have been is already in place, although some further lowering will develop.

We think what is developing in the world oil market is indicative of the continuation of working out the appropriate commodity prices in dollar terms that now is justified, given the significant rally in the value of the dollar. In fact, the world price of oil is currently inappropriate in dollar terms and presumably should be lower.

We do not anticipate that there will be further disruptions in that area.

But the point of this is the 5 percentage point reduction in overall prices brought about by that exceptionally strong dollar. We cannot anticipate further significant reductions of prices from the dollar strengthening unless, indeed, we currently believe the dollar is still undervalued. I cannot find anyone who believes in the longer term that that is true. In the short run it may very well be undervalued because of the significant demand for world liquidity by foreign investors. Certainly, with a current account deficit running in excess of $80 billion we will be supplying significant amounts of financial assets to foreign investors for many years to come it appears that at that rate we will fairly soon find a point where the foreign investors' liquidity needs will be met before we have brought the current account deficits down to a more sustainable level. That is another way of saying the dollar almost certainly will fall sometime in the future, but probably not until 1985.

The importance of that is that if we have lowered the inflation rates by about 2 percentage points a year in the last 2 years because of the strong dollar, and now we are talking about the potential of a reversal of the dollar in 1985, obviously we have to talk about increasing inflation.

I want to make one other point here, and this again goes at odds with a lot of people. I do not know if the Federal Reserve has been accommodative or restrictive in terms of domestic markets. I think in terms of the worldwide use of the dollar at the present time there is evidence that the Federal Reserve has been less than accommodative of world needs. In that regard I think there probably has been a mistake. In effect we have been strengthening the dollar unsustainably, in effect lowering our current inflation rates but creating an overhang of potential inflation when the dollar starts to slide downward.

I agree with Mr. Greenspan's analysis that when the dollar falls it will probably be necessary for us to raise short-term interest rates. But the issue here is, why are we, in fact, holding short-term interest rates up so high currently while the dollar is strengthening?

A more appropriate approach would be, indeed, to lower short-term interest rates at the current time, not permitting the dollar to strengthen to such an extent that we need a sharp correction in it in the future. Then, when the correction is forthcoming we can increase short-term interest rates from a lower base that will have less debilitating impact upon the overall economy.

To that extent, I really think there is strong argument for the Federal Reserve engaging in yet some further accommodative policy. At the very minimum they should be permitting money growth at the upper range of all of the targets. Given the money growth performance of the last 5 weeks, I would view the Federal Reserve as being slightly restrictive and less than appropriately responsive to what is happening in the international markets.

I do not want that to be a major criticism of the Federal Reserve. I think the Federal Reserve has done yeoman's duty in what we have achieved in the last several years in slowing down the overall inflation rates. To a large extent, even with a declining value of

the dollar anticipated for next year, we are not anticipating dramatic acceleration of inflationary pressures, and to some extent that has to be at the credit of the Federal Reserve.

However, I really firmly believe that the Federal Reserve needs to add in its measures of policy performance the performance of the dollar on both sides. There is evidence that the Federal Reserve indeed was concerned about a weakening dollar in March, in the last time policy tightened. But I think if we are all somewhat in agreement on one issue, and that is that the dollar is fundamentally overvalued, then the Federal Reserve should be working on both sides of the fence and should also be concerned when the dollar is unduly strengthening and should take that as a sign that there is a shortage of liquidity in the world markets which is a signal for somewhat more rapid money growth.

I think there will be time in the future to slow down and withdraw that growth in the money stock when the dollar ultimately starts to move downward toward its more appropriate levels.

Aside from those points, I think I would just like to reiterate the first issues that I brought out, which is that we are dealing with a very vigorous economic expansion, which, despite the very high rates of interest really does not show any signs of cyclical distortion. The distortions that concern all of us are the more long-term distortions created by high Government deficits and the high trade deficit.

Thank you.

[The prepared statement of Mr. Ratajczak follows:]

Prepared Statement of Donald Ratajczak

Thank you for inviting me to share my views on economic conditions at this time. Appended to this testimony are several tables indicating projections of economic conditions anticipated by the GSU Economic Forecasting Project in the next eight quarters. References will be made to some of the data contained in those tables during my presentation.

In summary, we are anticipating that economic activity will expand by 6.3% during the four quarters of 1984. Labor disruptions during the fourth quarter are expected to lower activity at that time by 1.5 percentage points at annual rates, of which one percentage point will be transferred into the first quarter of 1985. If those labor disruptions do not occur, real activity would expand 6.6%. Economic activity is expected to slow substantially in 1985, with growth projected to be 3.1% for the four quarters of that year.

Our estimates of inflation as measured by the GNP deflator are 4.0% in the four quarters of 1984, followed by an acceleration to 5.1% in 1985. These moderate rates of inflation are both the result of structural and special circumstances, some of which will not remain favorable much beyond 1985. More will be said about inflationary conditions below.

Despite the low inflation and reduced economic growth, increased corporate borrowings are expected to increase interest rate pressures through the early months of 1985 unless Federal Reserve policy becomes more accommodative. Treasury bills should reach 11.5% early in that year and average 10.5% in 1985. Rates are then expected to fall substantially, to less than 9% in 1986. Long-term Treasury yields should exceed 14% in 1985 before rallying to less than 11% in 1986.

Cyclical Imbalances Too Limited to Threaten Recession in 1985

Economic excesses that normally materialize prior to the onset of recession are not developing at this time. Business inventories rose more rapidly than sales during the first quarter, but that expansion was in response to unusually low inventory holdings that developed during the first year of economic expansion. Moreover, that pace of inventory expansion, which could not be sustained indefinitely at that rate, has since slowed to only a slightly more rapid rate of growth than the sustainable expansion of goods activity. Further moderation in the rate of inventory accumulation probably will be required early in 1985, when the growth of consumer activity is expected to moderate, but the

required adjustments at that time almost certainly will be too small to propel the economy into recession before the end of that year.

High real rates of interest also have prevented overall housing from charging into a boom that usually is followed by a significant bust. At prevailing mortgage rates modified by up to a two percentage point discount on effective mortgage rates for those home buyers electing adjustable rate mortgages, single-family housing sales appear to be stabilizing about 5% below previous year levels. Inventories of single-family homes are slightly excessive at 6.8 months of prevailing sales rates, but the magnitude of construction curtailments required to eliminate those excesses in the absence of further deterioration in housing sales, should also be modest.

A greater problem appears to be developing in rental units, where starts have been accelerating even as vacancy rates have been rising. Apparently, investor syndicates have sought properties for their tax consequence rather than for their apparent economic value. Also, some rental property probably was shifted into the first half of 1984 to avoid an anticipated reduction in tax benefits following the enactment of this year's "deficit downpayment". Substantial reductions in multi-family construction during the second half of 1984 will result in significant declines in housing expenditures at that time. However, barring significant increases in mortgage rates from current levels, total housing starts are expected to slip from a 1.93 million level in the first half of 1984 to 1.72 million in the latter half of the year. Starts are expected to average slightly less than 1.6 million in 1985, with the low point in the housing cycle being reached in the fourth quarter of that year at a level slightly less than 1.5 million. Although housing undoubtedly will experience economic weakness during the next two years, the magnitude of this anticipated decline is only half as abrupt as the normal housing falloff experienced during post-war recessions.

Although consumers clearly have sharply increased their borrowings, with consumer installment debt growing at a 30% annual rate during the second quarter of 1984, the ratio of debt to disposable income remains low in comparison to ratios prevailing prior to cyclical peaks. Furthermore, consumers have not been sharply reducing their rates of savings in order to engage in a spending boom. Although savings fell from 6.1% in the winter to 6.0% in the spring, this decline is more than explained by the termination of PIK distributions to farmers. Moreover, the 6.0% savings rate is the average for the post-war period and is more than a percentage point above savings rates prior to the 1980 recession.

The major impetus for strong consumer spending has been the moderation in consumer prices. Prices of furniture, gasoline, and apparel are below year-end levels, while downward pressures on oil prices have led to price moderation for all sources of energy, including electricity and natural gas. To some extent, consumers also have been converting previously appreciated asset values that developed during the 1983 stock market rally into increased consumer goods.

Even if prices remain moderate, consumer spending will slow. Real purchases of apparel have increased 14.5% in the last 12 months. Enough wardrobes must be refurbished by this time to result in reduced growth in the months ahead. Automobile sales now are 0.7 million above replacement needs. The average age of the automobile owned by consumers finally is beginning to fall. Only modest further gains in auto sales are expected from these levels. Even food consumption surged by an 8% real rate during the second quarter as

consumers sought greater food processing and also increased their meals away from home.

Some excesses are developing in commercial properties. Office vacancies currently are much higher than during the 1970s. However, vacancy rates appear to have stabilized as absorption rates have intensified. As with rental properties, some office building may have been stimulated by concern that tax treatment may be altered. As a result, spending on structures should slow noticeably in the second half of 1984. However, low construction costs also are encouraging increased activity. An office glut could be sufficient to curtail further expansion in commercial building by the end of 1985. However, increased construction for industrial space should moderate the impact that such a commercial building downturn otherwise would have upon the economy.

Spending for producers' durables also is expanding too rapidly to be sustained through 1985. As economic growth begins to slow, the growth of producers' durables also will moderate. A substantial squeeze in corporate profitability, owing either to sharply higher financial costs from rising interest rates or from a surge in wage pressures, could convert that moderation into an actual dip in spending for producers' durables late in 1985. A profits squeeze should develop, but it will not be sufficiently dramatic to curtail capital spending.

In short, the consumer is not overextended nor is the consumer fully satiated with goods. Rental properties may be excessive, but the magnitude of the anticipated housing correction should be far less than in previous housing declines. Commercial building may be excessive, but increases for industrial purposes should prevent any dramatic decline in spending on structures from developing during 1985. While a significant profit squeeze could encourage order cancellations, leading to a late 1985 dip in purchases of producers' durables, the magnitude of profit squeeze currently anticipated should not be sufficient to require such drastic cost-cutting measures. Thus, the overwhelming weight of evidence indicates that economic growth will slow, but the magnitude of slowing should not be sufficient to turn any of these correction areas into severely excessive conditions requiring dramatic production curtailments in order to eliminate the excesses. In other words, a substantial economic slowing is likely in 1985 but the degree of moderation should be orderly and should not cause a recession at the end of that year.

Longer-term Imbalances Remain in Government and Trade Deficits

Despite the absence of any significant economic excesses requiring a cyclical correction at the present time, the U.S. economy continues to be faced by two significant longer-term imbalances. Rapid economic growth has reduced the size of the government deficit, but our forecast indicates that such rapid growth cannot be sustained. Despite recently enacted legislation to reduce deficit pressures, our estimates indicate that the budgetary deficit will decline by only $5 billion in the next fiscal year. The reduced level of economic growth anticipated in our forecast will generate an increase in the deficit in the subsequent fiscal year. We cannot grow our way out of the deficit, unless we tolerate an inflation-induced expansion in the tax base. Should we be concerned by these deficits?

When I was invited to testify before this committee nearly two years ago, I argued that the issue of a government deficit revolves around the question of

the appropriate financing of government expenditures. Although some hold the view that a reduction in tax disincentives is always favorable, even when tax reductions are financed from increased borrowings, they do not go to the extreme of proposing that all taxes be eliminated and only borrownge be used to finance the government. Even they recognize that the compounding effect associated with interest expenses necessary to engage in such government financing soon would lead to a financially unstable economic condition. If borrowing is not always preferred to taxing, then some rule must exist to determine the appropriate mix of taxing and borrowing for any given economic condition. As a short-term financing rule, I argued that government deficits should be accepted or reduced in accordance with movements in the real rate of interest.

Currently, real interest rates are historically high. As a result, reductions in the government deficits that would prevail at high rates of economic activity should be encouraged. However, the cyclical distortions created by these high real rates do not appear to be substantial. The first six quarters of this economic recovery have been the most vigorous since the beginning of the Korean conflict. Housing and investment activity have rebounded sharply and even have generated some moderate signs of cyclical excesses in a few of their components. How much more balanced and more vigorous could the recovery have been with lower prevailing real rates of interest? If the results are acceptable, then something must have been done right. Although our projections indicate that interest rates will rise modestly into 1985, as reduced revenue expansion and increased wage costs lead to restraints upon corporate cash flow while they are still engaging in aggressive expansion programs, inflation-adjusted interest rates probably will decline modestly as inflation intensifies during the maturing of this cycle. In the latter part of 1985, when economic activity slows more significantly, real rates of interest will be declining more substantially. While reduced economic growth will add to government deficits at that time, economic distortion should not be intensifying as a result of those deficits. For that reason, programs to aggressively reduce the deficit in 1985 may prove to be cyclically inappropriate.

A Strong Dollar Lowers Prices by 5%

The second longer-term distortion is in the trade deficit. Recent estimates show that the dollar has rebounded by nearly 25% in comparison to 15 major trading partners since a 1980-82 base period. By the end of 1984, this dollar strengthening will have reduced prices by 5% from what they otherwise would have been if the dollar maintained its 1980-82 value. At the very least, such projections suggest that inflation has received a one-time moderating influence of slightly more than two percentage points per year in both 1983 and 1984. Removal of that moderating influence by itself would result in some intensifying inflationary pressures in 1985. If the dollar currently is unsustainably strong, and will need to decline in value in order to re-establish economic balance, then today's reduced inflation really is being borrowed from the future. As a result, an unsustainably strong currency could provide the illusion of inflationary restraint even as the potential for an inflationary surge is developing.

To answer whether the dollar is unsustainably strong, it is necessary to ask over what time period that question should be evaluated. At the present time, foreign investors have an enormous desire for liquidity in their investment portfolios. Because of financial risks inherent in an uncertain and volatile world, these investors have sought dollar-based assets to meet their

liquidity needs. Indeed, the dollar has strengthened because foreign investors desired even more financial assets than were being provided to finance the U.S. trade deficit.

While all statements about the dollar remain speculative, the shift in demand for dollar-based assets appears to reflect a one-time portfolio need by foreign investors. Once foreigners reach the desired concentration of dollar holdings in their portfolio, further increase in dollar demand will reflect only the growth of those portfolios. Moreover, any substitution of an alternative foreign currency for the dollar in meeting liquidity requirements could lead to a dramatic reversal in the exchange rate of our currency.

It is likely that a current account deficit well below the $85 billion currently projected for 1984 will be sufficient to provide the additional financial assets required to meet foreign investors' needs in the future.

I currently believe that a current account deficit of no more than $25 billion would be sufficient to sustain the portfolio requirements of foreign investors once their desired ratio of dollar-based to total assets has been achieved. Given prevailing cost conditions in the goods-producing industries of our trading partners, this would require approximately a 15% reduction in the trade-weighted value of the dollar to achieve the trade flows necessary to generate such a current account deficit.

Clearly, any erosion in the dollar's value during 1985 and beyond will replace the previous downward adjustment in prices by a one-time upward adjustment. Thus, the inflation rate could accelerate significantly beginning in the latter months of 1985.

In the short run, even a significant decline in the dollar's value would not dramatically intensify the rate of inflation. First, wage rates have been held sufficiently in check to prevent a surge in production costs during the next two years. Unit labor costs as a result of productivity gains in excess of 3% during 1984 along with compensation gains per hour of slightly less than 5%, are only increasing 2%. Even with a predicted slowing in productivity gains to an increase of 1.5% in 1985, and an acceleration in wage compensation to an hourly increase of 7%, unit labor costs will remain below 6% into 1986. Acceleration to slightly more than 6% for unit labor costs during that year appears to be the maximum that should be anticipated. Second, current excesses in oil production throughout the world should continue to restrain all energy prices through 1986. The world expansion remains sufficiently sluggish to prevent energy demand from outstripping production gains until that time. Third, agricultural capacity remains well above worldwide demand. The developing country debt crisis has restrained economic growth in those countries, while improved agricultural management has reduced external purchases from such populous countries as China and India. Therefore, even a weakening dollar in the years ahead would not generate dramatic acceleration in inflation.

Preserving Gains Against Inflation Must Be Primary Policy Objective

While inflation almost certainly will not move into the double-digit territory that some continue to expect in the next few years, the equally popular argument that a disinflationary spiral is leading to actual deflation is equally unlikely. The strong dollar has been a significant contributor to

restraining prices in the past two years. While some commodities have declined sharply in value in recent weeks, their value in Germany and Britain have not deteriorated. Except in the agricultural commodities and the highly sensitive precious metals, world prices of most commodities have not fallen. The absence of further dollar strengthening will reveal that underlying inflation is at least two percentage points higher than the price changes currently being revealed in the price indices.

Also significant in this inflationary slowing has been the performance of hourly earnings. Wages have been growing about a percentage point less rapidly than a relationship based upon employment conditions and inflationary conditions would predict. This additional percentage point of wage moderation can be related to reduced wage demands as a result of reductions in marginal tax rates. No further marginal tax rate reductions appear to be forthcoming. Moreover, the employee is scheduled to experience a significant increase in Social Security tax rates in January. As a result, this wage moderation should be reversed.

Moreover, as unemployment rates fall toward the "natural rate", increasing wage pressures relative to underlying inflation are inevitable. We currently estimate that the natural unemployment rate is slightly more than 6%. Labor markets will be in the vicinity of that rate by the fall of 1985.

Another danger of stimulating increased inflation is the current move toward increased protection of domestic markets from international competition. Some American industries need time to adjust to the new competitive pressures of a world economy. However, I would strongly urge that any measures leading to market restraints insure that the temporary protection is not converted into increased cost and price pressures. It would be helpful to have legislation indicating that any nonmarket trade arrangements be reviewed on an annual basis; that any review examine price changes relative to general inflation in the post-restraint environment as opposed to a typical period before restraints were imposed; and that wage rates in those protected industries also be reviewed in comparison to general manufacturing wage rates in an historical period prior to protection. Any acceleration in product prices or labor costs during the period of competitive restraints would constitute grounds to end those restraints in the subsequent year. Moreover, any industry subject to trade restraints which engages in work stoppages for the purpose of contesting labor-management relationships should have the trade restraint lifted by the amount of the production curtailment until the bargaining has been completed. In short, industries seeking such protection should not be permitted to use protection from competitive pressures to further reduce their long-term competitive viability.

Appropriate Monetary Policy

Considering the performance of the economy both in terms of inflation and real activity since the beginning of this recovery, the magnitude of criticism concerning both budgetary and monetary policy appears to be inappropriate. The Federal Reserve has not killed the recovery with undue restraint. Neither has it threatened the economy with a quick return to double-digit inflation. At least there are few early warning signals that such inflationary surges are developing on the horizon. On the other hand, some of our favorable inflationary performance has been borrowed from the future in the form of unsustainably high dollar values. While the Federal Reserve has indicated that it will counter the force of any inflationary avalanche created by a falling dollar, it has not indicated prudence in reducing the potential size of that

avalanche by increasing money growth to meet foreign investor portfolio needs. At the present time, the Federal Reserve should add a currency rule to its group of policy measurements. A strengthening in the value of the dollar from current levels should be met with increased bank reserves and a reduced Federal funds rate. The Federal Reserve demonstrated in March that it would become more restrictive if the dollar showed signs of weakening, but it now must show that it will become more accommodative when currency scarcity in world markets is revealed by a rising dollar value. Thus, the Federal Reserve should state that it will provide additional reserves to counter such currency gains even if the result would be a reduction in short-term interest rates.

Although the above comments only touch upon my forecast for economic activity in the next two years, the accompanying tables clearly show what inflation and economic conditions are expected by GSU in the next two years. I feel confident about the forecast, but I am concerned by the rush to solve a government deficit problem after an economic expansion already has begun to lose steam. Unfortunately, the appropriate cyclical time to address the deficit issue has already passed. I am also concerned with how much of the current moderate inflationary performance has been borrowed from the future by permitting the dollar to rise to a value that cannot be sustained. An otherwise diligent Federal Reserve appears to have failed us on this particular point. (It also should be apparent by the shifting requirements in financial markets resulting from bank and loan problems as well as foreign investor liquidity needs that any rigid restraints upon Federal Reserve monitoring of monetary flows would be counterproductive.) I hope these comments help your deliberations and I will welcome any questions or comments that you may have.

Table 1.

Georgia State University
College of Business Administration
Economic Forecasting Project
August 1984

U.S. Expenditures for 1984-I and 1984-II with Forecasts for 1984-III through 1986-II

	1984				1985				1986		Percent Change			Annual		
	I	II	III	IV	I	II	III	IV	I	II	82-83	83-84	84-85	1983	1984	1985
1. Personal Consumption Expenditures	2276.5	2326.7	2370.7	2413.6	2461.8	2507.1	2552.6	2605.9	2660.8	2715.3	8.6	8.9	7.9	2155.9	2346.9	2531.9
2. Autos and Parts	147.7	152.0	155.2	154.0	159.5	159.4	161.5	165.3	168.4	170.8	19.0	17.7	6.0	129.3	152.2	161.4
3. Other Durable Goods	163.2	166.7	169.2	171.7	174.0	176.9	179.4	183.0	185.8	189.2	10.3	11.4	6.3	150.5	167.7	178.3
4. Nondurable Goods	841.3	857.8	869.3	884.1	897.4	912.0	925.2	941.4	959.3	975.9	5.8	7.7	6.5	801.7	863.1	919.0
5. Services	1124.4	1150.2	1177.0	1203.8	1230.9	1258.8	1286.5	1316.2	1347.3	1379.4	9.4	8.3	9.4	1074.4	1163.4	1273.1
6. Gross Private Domestic Investment	623.8	631.5	646.1	655.1	666.0	678.8	688.2	697.6	698.7	710.1	13.7	35.5	6.8	471.6	639.1	682.7
7. Residential Structures	151.2	156.6	156.8	151.7	151.6	149.6	148.5	143.2	141.4	147.6	44.6	16.6	-3.8	132.2	154.1	148.2
8. Other Structures	142.2	152.1	159.7	167.5	175.6	182.2	188.0	193.1	198.1	202.3	-8.7	19.8	18.9	129.7	155.4	184.7
9. Producers' Durables	256.7	265.1	280.3	287.4	295.7	300.5	306.4	313.8	320.0	325.8	7.6	22.5	11.2	223.2	273.4	304.1
10. Change in Inventories	73.8	53.8	49.3	48.5	43.1	46.5	45.3	47.5	39.2	34.4	-	-	-	-13.5	56.4	45.6
11. Net Export of Goods and Services	-51.5	-58.0	-55.1	-57.7	-52.4	-54.3	-50.7	-51.4	-44.4	-44.0	-	-	-	-3.1	-55.6	-52.2
12. Exports	358.9	371.4	376.3	384.0	396.2	407.5	420.5	431.7	446.4	459.0	-3.5	10.9	11.1	336.2	372.7	414.0
13. Imports	410.4	429.4	431.6	441.7	448.6	461.8	471.2	483.1	490.8	503.0	4.5	24.4	8.8	344.4	428.3	466.2
14. Government Purchases of Goods and Services	704.4	746.1	763.6	780.8	803.3	820.5	838.7	857.0	881.0	899.6	5.4	9.2	10.8	685.6	748.7	829.9
15. Federal	267.6	299.3	307.5	314.8	328.0	335.1	343.2	351.0	364.2	371.8	4.2	10.2	14.1	269.8	297.3	339.3
16. National Defense	213.4	221.3	226.7	232.2	242.4	248.4	255.4	261.7	272.5	278.0	11.7	11.4	12.8	200.5	223.4	252.0
17. Other, including NASA	54.2	78.0	80.8	82.6	85.6	86.7	87.8	89.3	91.7	93.8	-12.8	16.2	8.6	69.3	80.5	87.4
18. State and Local	436.8	446.7	456.1	466.0	475.3	485.4	495.5	506.0	516.8	527.8	6.2	8.6	8.7	415.8	451.4	490.6
19. Gross National Product	3553.3	3646.4	3725.3	3791.8	3878.7	3952.1	4028.8	4109.1	4196.1	4281.0	-	-	-	3304.8	3679.2	3992.2
20. Amount of Change	121.6	93.1	78.9	66.5	86.9	73.4	76.7	80.3	87.0	84.9	-	-	-	235.5	374.4	313.0
21. % Change*	14.9	10.9	8.9	7.3	9.5	7.8	8.0	8.2	8.7	8.3	-	-	-	7.7	11.3	8.5
22. % Real Change*	10.1	7.5	5.2	2.4	3.8	2.9	3.0	2.9	2.2	2.6	-	-	-	3.7	7.2	3.6
23. % Price Change*	4.4	3.2	3.5	4.8	5.5	4.8	4.9	5.2	6.4	5.6	-	-	-	3.8	3.8	4.7
24. Implicit Price Deflator	220.58	222.31	224.24	226.89	229.93	232.61	235.41	238.42	242.14	245.48	-	-	-	215.34	223.51	234.09
25. Change in Final Sales	60.5	113.0	83.4	67.3	92.3	70.0	77.9	78.1	95.3	89.7	-	-	-	222.9	290.2	328.1
26. GNP in 1972 Dollars	1610.9	1640.2	1661.3	1671.2	1686.9	1699.0	1711.4	1723.5	1732.9	1743.9	-	-	-	1534.7	1645.9	1705.2

Table 2.

Georgia State University
College of Business Administration
Economic Forecasting Project
August 1984

U.S. Real Expenditures for 1984-I and 1984-II with Forecasts for 1984-III through 1986-II

	1984				1985				1986		Percent Change			Annual		
	I	II	III	IV	I	II	III	IV	I	II	82-83	83-84	84-85	1983	1984	1985
1. Personal Consumption	1044.1	1061.7	1073.4	1081.0	1090.5	1098.2	1105.5	1114.7	1122.7	1130.2	4.8	5.5	5.5	1009.2	1065.1	1102.2
2. Durable Goods	175.7	177.6	180.2	180.0	183.2	183.8	184.6	186.8	188.2	189.5	12.1	13.0	5.8	157.5	177.9	184.7
3. Nondurable Goods	387.1	396.0	400.4	403.7	406.0	408.9	411.2	414.2	416.8	419.0	3.7	5.4	3.4	376.4	396.8	410.1
4. Services	483.4	488.0	492.8	497.3	501.3	505.5	509.5	513.7	517.7	521.9	3.4	3.2	3.5	475.4	490.4	507.5
5. Gross Private Domestic Investment	285.5	286.2	291.4	292.4	294.1	297.0	297.9	298.8	295.4	296.6	13.7	30.7	2.8	221.0	288.9	297.0
6. Residential Structures	60.6	62.0	61.7	59.1	58.5	57.1	56.1	53.5	52.2	53.8	41.7	13.4	-7.6	53.7	60.9	56.3
7. Other Structures	54.1	57.7	60.5	63.1	65.5	67.2	68.5	69.4	70.1	70.5	-7.8	19.7	14.9	49.2	58.9	67.7
8. Producers' Durables	139.2	144.9	150.4	152.4	155.4	157.0	158.5	160.1	161.6	162.5	7.3	20.4	7.6	121.8	146.7	157.8
9. Change in Inventories	31.6	21.5	18.8	17.8	14.7	15.7	14.8	15.8	11.5	9.8	-	-	-	-3.6	22.4	15.3
10. Net Export of Goods and Services	-8.3	-10.0	-9.6	-11.0	-9.2	-10.0	-8.5	-8.7	-5.8	-5.4	-	-	-	12.6	-9.7	-9.1
11. Exports	144.9	148.8	150.3	152.2	155.0	157.3	160.1	161.9	165.0	167.0	-5.5	6.9	6.4	139.5	149.1	158.6
12. Imports	153.2	158.8	159.9	163.2	164.2	167.3	168.6	170.6	170.8	172.4	7.6	25.1	5.6	126.9	158.8	167.7
13. Government Purchases of Goods & Services	289.5	302.4	306.1	308.8	311.5	313.8	316.5	318.7	320.6	322.5	-0.3	3.4	4.4	291.9	301.7	315.1
14. Federal	112.2	123.7	126.1	127.8	129.5	130.9	132.6	133.9	135.1	136.2	-0.6	5.4	7.5	116.2	122.5	131.7
15. State & Local	177.3	178.7	180.0	181.0	182.0	182.9	183.9	184.8	185.5	186.3	0.0	2.0	2.3	175.7	179.3	183.4
16. Gross National Product	1610.9	1640.2	1661.3	1671.2	1686.9	1699.0	1711.4	1723.9	1732.9	1743.9	3.7	7.2	3.6	1534.7	1645.9	1705.2
17. Final Demand	1579.3	1618.7	1642.5	1653.4	1672.2	1683.3	1696.6	1707.7	1721.4	1734.1	3.2	5.5	4.1	1538.3	1623.5	1690.0
18. Private Domestic Product	1431.5	1459.8	1481.2	1490.4	1505.7	1516.8	1528.6	1540.0	1548.8	1558.8	4.2	8.2	3.9	1355.1	1465.7	1522.8

Table 3.

Georgia State University
College of Business Administration
Economic Forecasting Project
August 1984

Implicit Price Deflators for Personal Consumption Expenditures for 1984-I and 1984-II with Forecasts for 1984-III through 1986-II

	1984				1985				1986		Percent Change			Annual		
	I	II	III	IV	I	II	III	IV	I	II	82-83	83-84	84-85	1983	1984	1985
Durable Goods	179.0	179.4	180.0	180.9	182.0	183.0	184.5	186.5	188.2	190.2	1.8	1.2	2.3	177.7	179.8	184.0
% Change	-0.5	0.8	1.4	2.1	2.5	2.2	3.3	4.5	3.7	4.3						
Automobiles	196.3	196.6	197.4	199.8	200.9	201.8	203.7	206.4	208.2	210.6	1.8	1.8	2.9	194.1	197.5	203.2
% Change	0.0	0.6	1.6	5.0	2.3	1.9	3.7	5.5	3.5	4.6						
Furniture	157.6	157.8	158.2	158.6	159.3	160.2	161.0	161.9	163.0	164.1	0.9	0.0	1.6	158.1	158.1	160.6
% Change	-2.3	0.5	0.9	1.1	1.6	2.2	2.0	2.3	2.6	2.8						
Other Durables	188.0	188.5	188.4	188.7	189.9	191.4	193.8	196.5	199.6	202.6	2.6	1.4	2.4	185.8	188.4	192.9
% Change	1.7	1.1	-0.3	0.7	2.5	3.1	5.2	5.6	6.5	6.3						
Nondurables	217.4	216.6	217.1	219.0	221.0	223.0	225.0	227.3	230.2	232.9	3.1	2.1	3.0	213.0	217.5	224.1
% Change	4.9	-1.4	0.9	3.5	3.8	3.7	3.6	4.1	5.1	4.8						
Food	228.8	228.4	230.2	232.9	235.3	238.0	240.5	243.3	246.7	250.0	2.4	4.4	4.0	220.5	230.1	239.3
% Change	12.0	-0.7	3.2	4.7	4.3	4.6	4.3	4.8	5.6	5.5						
Apparel	144.4	144.1	143.7	144.2	145.0	145.6	146.8	148.1	149.6	151.3	1.8	0.3	1.6	143.6	144.1	146.4
% Change	-2.5	-0.8	-1.2	1.4	2.3	1.8	3.1	3.5	4.3	4.4						
Gasoline & Oil	340.6	342.9	337.5	339.6	343.1	345.7	347.3	348.9	351.2	354.0	-3.3	-1.4	1.8	344.9	340.2	346.3
% Change	-9.3	2.7	-6.6	2.5	4.2	3.1	1.8	1.9	2.6	3.2						
Fuel Oil	550.0	551.9	548.1	553.4	562.1	569.3	570.5	575.8	586.4	594.1	-6.9	3.7	3.4	531.3	550.9	569.4
% Change	14.5	1.4	-2.8	3.9	6.5	5.2	0.9	3.8	7.6	5.3						
Other Nondurables	217.5	218.3	219.7	221.5	223.6	226.0	228.5	231.2	234.4	237.7	6.8	2.7	3.6	213.6	219.3	227.3
% Change	2.8	1.5	2.6	3.3	3.8	4.3	4.5	4.9	5.6	5.7						
Services	232.6	235.7	238.8	242.1	245.5	249.0	252.5	256.2	260.2	264.3	5.8	5.0	5.7	226.0	237.3	250.8
% Change	5.0	5.5	5.4	5.6	5.8	5.9	5.7	6.0	6.5	6.5						
Housing	218.4	221.9	225.0	228.2	231.5	235.0	238.5	242.1	246.0	249.8	6.4	5.3	6.0	212.1	223.4	236.8
% Change	4.5	6.6	5.8	5.8	5.9	6.1	6.2	6.2	6.5	6.3						
Electricity & Gas	333.0	336.8	340.9	346.1	349.9	354.8	359.4	364.9	370.1	376.3	6.7	4.0	5.3	326.2	339.2	357.3
% Change	1.7	4.6	4.9	6.2	4.5	5.7	5.3	6.3	5.8	6.9						
Household Operations	194.6	196.8	198.1	199.9	203.5	205.7	207.9	210.1	213.0	215.7	5.6	6.4	4.9	185.2	197.1	206.8
% Change	16.5	3.3	4.4	3.6	7.5	4.3	4.5	4.3	5.6	5.2						
Transportation	234.6	237.8	241.3	244.7	248.4	251.6	255.0	258.9	262.9	267.0	5.9	4.7	5.8	228.9	239.6	253.5
% Change	4.4	5.6	6.0	5.7	6.3	5.3	5.5	6.2	6.4	6.3						
Other Services	239.3	242.2	245.3	248.5	252.0	255.6	259.3	263.2	267.3	271.5	5.1	4.8	5.6	232.7	243.8	257.5
% Change	5.2	4.9	5.2	5.4	5.6	5.8	6.0	6.2	6.3	6.5						
Personal Consumption Expenditures	218.0	219.2	220.9	223.3	225.7	228.3	230.9	233.6	237.0	240.2	3.7	3.2	4.2	213.6	220.4	229.7
% Change	3.8	2.1	3.1	4.4	4.3	4.7	4.6	5.1	5.6	5.6						
Consumer Price Index	306.8	309.6	312.0	316.1	320.0	324.6	328.5	333.2	338.2	343.4	3.2	4.3	5.0	298.4	311.1	326.6
% Change	5.0	3.7	3.2	5.4	5.3	5.6	4.9	5.8	6.2	6.3						

Table 4.

Georgia State University
College of Business Administration
Economic Forecasting Project
August 1984

Implicit Price Deflators with Annual Percentage Changes for 1984-I and 1984-II with Forecasts for 1984-III through 1986-II

	1984				1985				1986		Percent Change			Annual		
	I	II	III	IV	I	II	III	IV	I	II	82-83	83-84	84-85	1983	1984	1985
GNP Deflator	220.58	222.31	224.24	226.89	229.93	232.61	235.41	238.42	242.14	245.48	3.8	3.8	4.7	215.34	223.51	234.09
% Change	4.4	3.2	3.5	4.8	5.5	4.8	4.9	5.2	6.4	5.6						
Personal Cons. Exp.	218.0	219.2	220.9	223.3	225.7	228.3	230.9	233.8	237.0	240.2	3.7	3.2	4.2	213.6	220.4	229.7
% Change	3.8	2.1	3.1	4.4	4.5	4.7	4.6	5.1	5.6	5.6						
Private Domestic Investment	218.5	220.6	221.7	224.0	226.5	228.6	231.0	233.5	236.5	239.4	-0.1	3.7	3.9	213.4	221.2	229.9
% Change	3.9	3.9	2.1	4.3	4.5	3.7	4.3	4.5	5.3	5.0						
Structures	262.6	263.5	264.0	265.5	268.1	271.1	274.5	278.3	282.6	286.9	-1.1	0.1	3.4	263.7	263.9	273.0
% Change	-4.9	1.4	0.8	2.3	3.9	4.5	5.1	5.7	6.3	6.2						
Producers' Durables	184.4	185.7	186.4	188.6	190.3	191.4	193.3	196.0	198.0	200.5	0.6	1.6	3.5	183.3	186.3	192.8
% Change	-3.0	2.8	1.6	4.9	3.7	2.4	3.9	5.6	4.2	5.1						
Residential Structures	249.4	252.6	254.1	256.7	259.2	262.0	264.7	267.6	270.8	274.4	2.1	2.8	4.0	246.4	253.2	263.4
% Change	1.9	5.1	2.4	4.2	3.9	4.4	4.1	4.4	5.0	5.4						
Exports	247.7	249.6	250.5	252.3	255.6	259.0	262.7	266.6	270.5	274.8	2.1	3.7	4.4	241.0	250.0	261.0
% Change	3.7	3.2	1.4	2.9	5.3	5.4	5.8	6.1	6.0	6.4						
Imports	267.9	270.3	270.0	270.7	273.2	276.1	279.5	283.2	287.3	291.7	-2.8	-0.7	3.1	271.5	269.7	278.0
% Change	-3.5	3.7	-0.5	1.1	3.7	4.3	5.0	5.4	5.9	6.3						
Federal	238.5	241.9	243.8	246.3	253.3	256.0	258.8	262.1	269.7	273.0	4.8	4.5	6.2	232.1	242.6	257.6
% Change	5.0	5.9	3.1	4.2	11.8	4.4	4.5	5.2	12.1	4.9						
Federal Purchases	254.5	257.7	260.1	263.5	267.2	271.1	275.4	279.7	284.2	289.0	5.2	3.8	5.6	249.5	259.0	273.4
% Change	-2.0	5.1	3.7	5.3	5.7	6.0	6.5	6.4	6.6	7.0						
Federal Value Added	219.6	220.3	220.4	221.3	232.7	233.0	233.3	234.7	246.8	247.1	4.8	5.0	5.9	209.9	220.4	233.4
% Change	15.6	1.3	0.2	1.7	22.2	0.5	0.5	2.5	22.2	0.4						
State & Local	246.4	250.0	253.4	257.4	261.1	265.4	269.4	273.9	278.6	283.3	6.2	6.4	6.2	236.7	251.8	267.5
% Change	7.8	6.0	5.5	6.5	5.9	6.7	6.2	6.8	7.0	6.9						
State & Local Purchases	256.2	258.8	260.9	263.9	267.3	271.2	274.9	279.0	283.5	288.2	3.4	4.4	5.0	249.1	260.0	273.1
% Change	5.7	4.1	3.3	4.7	5.3	5.9	5.7	6.1	6.6	6.8						
State & Local Value Added	239.6	243.9	248.1	252.8	256.9	261.3	265.5	270.2	274.8	279.5	8.2	7.7	7.1	228.5	246.1	263.5
% Change	8.8	7.4	7.0	7.7	6.6	7.0	6.5	7.3	7.0	7.1						

Representative WYLIE. Thank you very much, Mr. Ratajczak, for your excellent testimony. This has been a very thought-provoking panel this morning, to say the least, and we do appreciate your testimony.

Mr. Greenspan informed me as he came in this morning of an emergency situation which has arisen and indicated that he will have to leave by about eleven o'clock. If it is agreeable with the rest of the panel, we would like to go ahead with questions of Mr. Greenspan at this time.

Does anyone else have a timeframe problem? [No response.]

Hearing no objection to that, then I think we will do that.

Mr. Greenspan, you mentioned in your testimony that there are the obvious budget questions. I think that is the way you put it. And that could be a problem. Do you have a suggestion as to how we might go about bringing down the budget deficit? I say that because I feel it's a problem myself and have continuously thought that we ought to do something about that, at least, perhaps, if we are looking to fiscal year 1985 and beyond.

Mr. GREENSPAN. Mr. Chairman, there is no question that the deficit has to be brought down. But it is also important to remember what the purpose of and budgetary actions is to do that. The reason I think the President is making such a strong point on the question of taxes is it is his view, with which, I must say, I have some considerable sympathy, solely raising taxes does not necessarily reduce the deficit, especially over the long run. It is fairly obvious that we still have built into our system an upward bias toward expanding benefits and expenditures, and that if all we do is supply revenues to the system with no restraint on expenditures, I suspect that we will find, in the end, that we did not reduce the Federal budget deficit; all we succeeded in doing was raising the share of GNP going to Federal expenditures.

I am also obviously fully aware that with the size of the current services deficits which confront us and the presumed disinclination on the part of the Congress, and perhaps even the administration, to make the types of cuts in outlays which would remove any need for additional revenues, some revenue increase is likely as part of a package. I've argued for quite a while that what we need is some agreement amongst the major political parties and constituencies in the country to share what is obviously pain. In other words, bringing the deficit down means removing benefits from constituents and increasing tax burdens on constituents. It is fairly apparent that that is not something which our political system does with relish or which is done with ease. It requires some basic agreement, I would presume after the election, in which all parties come to a specific and general agreement on the type of budget reduction package that is to occur.

If that is accomplished, then I would suspect the financial markets would be shocked into a state of benevolence that they now do not harbor.

The payoff of a major, real, credible, long-term reduction in the budget is extraordinarily large. I think not to do it foregoes a major potential long-term benefit to the country.

Representative WYLIE. It seems to me that you have pointed to a dilemma which I have been talking about for some time, and that

is coming to some agreement between members of both parties and people of various political interests. The problem is that there is a difference of opinion as to where these reductions should be made, as you know, legitimate provincial interests. And when you start talking about expanding benefits and that entitlement programs have to be looked at, I agree with that, and yet the entitlement programs make up 40 percent of the total budget right now; defense makes up about 27 percent; controllable make up about 25 percent. And I think Congressman Obey did us a service when he offered an amendment to reduce controllables by 63 percent in the next fiscal year budget. Obviously it didn't pass. As a matter of fact, I think he got about 10 votes on his amendment.

Mr. GREENSPAN. That's surprisingly large.

Representative WYLIE. Surprisingly, a large number of votes. That's correct.

Representative SCHEUER. May I comment?

Representative WYLIE. Yes, of course.

Representative SCHEUER. Dave Obey did that for a specific educational purpose. That 63-percent, or whatever it was, reduction was what it would take to even marginally approach a balanced budget without making any complementary reductions in the military budget.

Representative WYLIE. Without making reduction in entitlements or the military budget.

Representative SCHEUER. Yes. And he was trying to show how bizzare that approach was and that we had better start thinking seriously about a balanced package of alternatives.

Representative WYLIE. Right.

Well, having said that, I want to compliment you, Mr. Greenspan, for a truly outstanding job on the social security funding problem commission. You came up with a package which we voted on: Yes or no, do you want to save the social security fund or don't you want to save it? No amendments or anything like that. I have been suggesting some sort of a commission like that, a budget reductions commission, and I might even suggest that you would want to be chairman of it, or suggest your name as chairman of it.

What would you think of a budget reductions commission made up of five members appointed by the President, five by the Speaker of the House, five by the majority leader—the President can't appoint more than three Republicans; the Speaker can't appoint more than three Democrats—made up of people from credit-sensitive industries to address this problem that we have with the deficit? What would you think of that?

Mr. GREENSPAN. Mr. Chairman, I think that it does reflect something important that we learned during the social security deliberations; namely, that unless you have a single solution subscribed to by all of the key people involved in those decisions, it is almost impossible to reach an agreement. The commission approach to the budget issue may be the most desirable way of going at it provided that the key members of that commission carry the political proxies of the relevant constituent groups and the relevant political leaders of the country. To have a group of distinguished Americans bring a series of recommendations to the administration and the

Congress may be interesting, but it is doomed to failure. What we need is not recommendations, but negotiations.

It may be that as in the Social Security Commission a commission can be the vehicle through which the critical negotiations can take place. Something equivalent to it has to occur. Whether it is the old "Gang of 17," which was a congressional administrating group, or its equivalent in a commission is probably not as important as that the proxies of the key political leaders are held by members of that group if they themselves are not actually members of it.

Representative WYLIE. Frankly, I think we have a problem vis-a-vis the budget deficit, and I think that the so-called bipartisan budget reductions commission holds the most promise right now. So I have been promoting that, and Congressman Les AuCoin and I have put a bill in to do that, and we have 162 cosponsors.

You didn't comment very much on monetary policy, Mr. Greenspan, in your testimony. Others did. What do you think about it? How is the Federal Reserve Board doing?

Mr. GREENSPAN. Considering the type of economic environment which they are confronting, they are doing rather well. It is very easy in retrospect to say they did one or another thing wrong; tightened a little too much or were a little too easy. There is no way to be exactly correct on monetary policy. But ultimately you have to look at the results.

There are really two major threats to the economy which the Federal Reserve can often be accused of creating. One is inadequate economic growth through excessive monetary tightness, which clearly cannot currently be put at the doors of the Fed. We are having exceptionally good economic growth. The other side is that they are excessively easy, creating too much money and driving inflation higher. There, too, they cannot be criticized.

So I am sure that one can find that they could have done something better, but you can't quarrel with results. That's the bottom line. So as far as I am concerned, for whatever reason, they have done well, and I think probably for the right reasons.

Representative WYLIE. Thank you.

You alluded to this question in your testimony, but I want to review the approach here. What are the factors influencing interest rates? Are they too high, too low, or about right?

Mr. GREENSPAN. You have to distinguish between the short end of the market and the long end of the market. I realize that Professor Fand and I disagree on the long end, although we may not disagree as much as I think.

In any event, I think the historical evidence suggests that the real riskless long-term rate under almost any conditions rarely gets above 5 percent and that it usually hovers in the area of 2½ to 3 percent. The current 13 percent long-term U.S. Treasury yields probably include at least an 8 or 9 percent inflation premium. Unless and until the long-term inflation expectations are lowered, either through the budget process or resolving some of the concern with respect to the American banking system, those rates are not going to come down appreciably.

You cannot, however, argue that short-term interest rates are inflation premium based, because overnight money clearly cannot be

considered to be involved with these long-term inflation expectations. Here I believe we are looking at the balance sheet problems of borrowers in the sense that we have what I perceive to be an inordinate amount of chronic distress borrowing. In economic terms, the short-term demand for funds is inelastic, meaning, in effect, that people have to borrow irrespective of what the interest rate is and as a consequence of that will tend to move rates higher than they would otherwise be.

That is resolvable largely through a resolution of what is a chronic long-term problem in American private balance sheets. We have, in effect, too much debt, and interest rates are the price of debt. If you've got too much of it, it shouldn't be a surprise that rates are high.

So I would say that they are the two major pillars of rates being higher than they have been historically.

Representative WYLIE. Thank you very much.

I know, Congressman Scheuer, you have some questions for Mr. Greenspan.

Representative SCHEUER. I suppose interest rates are also a factor of the need to borrow, and the interest rates on our Government securities is a question of the number of investors at home and abroad who want to invest.

You mentioned that there was a dollar glut in international mobile portfolios.

Mr. GREENSPAN. Approaching dollar glut.

Representative SCHEUER. Did you mean to suggest that there is likely to be a disinvestment process by foreign dollar holders over some period of time?

Mr. GREENSPAN. No. I think what we will get is a slowdown in the rate of increase of holdings. For example, let us assume, however one measures it, that 80 percent of the holdings in portfolios of banks, companies, governments, central banks are in dollars, 20 percent in other currencies, and that there is an extraordinarily strong demand for dollars. What I am saying is, if the demand is based, as it clearly is, on high U.S. real interest rates relative to other currencies and a very strong sense of safe havenness, even if those do not change, there has got to be some point when that 80 percent goes to 85 percent, 90 percent, or 95 percent, and eventually, say, to 100 percent, where everyone thinks the dollar is terrific but there is no more need to purchase dollars. Hence the flow of dollars falls with the demand for dollars, and since it is the net flow of dollars for financial purposes which is keeping the exchange rate above its so-called purchasing power parity, when that demand falls off the exchange rate will fall. And that is the process which I think will eventually occur.

The trouble, unfortunately, is that our data are so poor that it is very difficult to pinpoint it. I had thought we would already be in the process, but we obviously are not. One looks at the markets and finds very little evidence that we are about to hit that button. But that we have to reach it is a numerical absolute.

Representative SCHEUER. You mentioned at one point in your colloquy with the chairman that you were deeply concerned about the deficit, as we all are, and that you thought that major spending cuts should be made. Later on in your remarks you mentioned

spending cuts and tax increases. But you didn't at that point. Have you ever put together a program of spending cuts that would put us, even in the middle term, on the road to balancing that budget without a tax increase?

Mr. GREENSPAN. I would argue that it is not necessary to balance the budget. While I must admit I would like to see the budget balanced, if our purpose is to reduce long-term interest rates, all we have to exhibit to the international financial community is a current services gap between receipts and expenditures which indicates a declining ratio of deficit to the GNP over the long run. That alone will bring rates down.

At this particular point, if you ask me can I arithmetically change the structure of spending to bring it down, of course I can. So can you. The question is, What usefullness is that exercise in the context of the fact that every single line in the budget has some constituency involved with it. The budget is a reflection of the political tradeoffs in this country. It is not a numerical issue; it's a very profoundly important political issue in our democratic society.

Representative SCHEUER. That's absolutely true. But it seems to me it is up to the economists as a professional group to give both the Congress and the President their best idea, their best conception as to what we ought to be doing. In a more perfect world we would be doing whatever that consensus was, if you could ever achieve it. In the world that we know of political tradeoffs we will be doing something like that, hopefully reasonably close to that. If you had your job back, if I were able to tap you with a wand and you were again Chairman of the Council of Economic Advisers, what would you be suggesting to, let's say, the President to reduce somewhat the political pressures of the moment? What would you be advising the President of the United States come January 1 of 1985 as to a reasonable mix between budget reductions, military, and entitlements, and tax increases or revenue enhancement, however you wish to describe them?

Mr. GREENSPAN. I suspect were I in that position I wouldn't be answering the question right now. And the reason I wouldn't is that I don't think it is the job of economists to make value judgments about national priorities to the Congress; it is on the edge of presumptuousness which I think is really quite inappropriate.

Now it is certainly the case that I would, in the hypothetical case which you raised, be involved in trying to elevate all the various options and their economic implications but I don't think you should get economists making value judgments for the American people. I don't think we should. What we should do, in fact what we are doing, is say what are the financial implications of the borrowing levels, what do they do to the country, what do they do to the economy. But for an economist to specify what the appropriate level of national defense expenditures is, is outside of our field.

Representative SCHEUER. I suppose you could provide a President with a balanced smorgasbord of options that would produce that result. If we got a good deficit reduction package, presumably composed both of tax increases and of spending reductions, wouldn't that, in effect, help bring interest rates down and wouldn't that

shift make possible a long period of sustained noninflationary growth?

Mr. GREENSPAN. Unquestionably. But I would make one important requirement to that package: That it is credible to the financial community as a deficit reduction package. And that is the reason why I raised the issue before of being careful not to solve the budget deficit problem wholly from the tax side. The markets won't believe it.

Representative SCHEUER. There is no question about it. But do you think that this very sophisticated financial community that you are talking about would find it credible to see a package of spending reductions without any tax increases?

Mr. GREENSPAN. I will put it to you this way, Congressman Scheuer. If the Congress passed it and the President signed it, they'd believe it.

Representative WYLIE. On that happy note, why don't we suggest that we will excuse Mr. Greenspan. I indicated that we would get you out of here by about 11 o'clock, and I think it is now about 2 minutes after.

Mr. Greenspan, thank you very much for your excellent testimony. You always help us in our deliberations on this committee, and we do appreciate your taking the time to be with us.

Representative SCHEUER. May I have 30 seconds?

Representative WYLIE. You may have 30 seconds.

Representative SCHEUER. I wish to join my colleague in expressing my admiration for the spectacular job you did in putting together that social security package. And the proof of the incredible success that you achieved, that you achieved for all of us in this country and all 535 Members of Congress, was that everybody complained a little bit, but nobody complained very, very much. And no matter who came in to complain, you could sit down with them and show them who else got a little bit stuck, and they would leave a little bit disgruntled, but never rebellious. That was a tremendous achievement, and we are all in your debt.

Representative WYLIE. Indeed it was. Thank you very much again, Mr. Greenspan. You are excused. We appreciate your appearance.

Mr. GREENSPAN. Thank you very much.

Representative WYLIE. We will go ahead with the questions from the rest of the panel, if we may.

On a little bit different note, back to you, Mr. Ratajczak, you indicated that you thought that borrowing from abroad might decrease, that maybe there would be some attempt to dispose of some of the American dollars. What about the forecast that we saw this morning that oil might drop to $15 a barrel as early as 1985? What impact would that have as far as you are concerned?

Mr. RATAJCZAK. The decline in the price of oil appears to be a working out of the dramatic increase in the world purchasing power of the dollar. In effect, excluding the United States, oil has become a very expensive commodity, and this is one of the reasons why the demand for oil has not significantly increased.

However, a drop to $15 a barrel would be more than appropriate to bring an appropriate realignment back between oil and other

commodities traded in world markets. Certainly a 3-to-5-dollar-a-barrel decline would be something that could be anticipated.

Having said that, let me say obviously that would be beneficial in the near term to the United States. We are a major purchaser of foreign oil. This would certainly help to moderate the current account deficits, and anything we can do to significantly lower the amount of dollar value of imports that we are purchasing will go some way toward moderating the ultimate correction that the dollar will have to take.

I should also point out that I really very much share the viewpoint of Mr. Greenspan on this. Not that the dollar itself is going to be disgorged out of inventories abroad, but rather, at some point, the desired composition of dollars in those portfolios will have been reached. At that point the demand for dollars will have lessened. Unfortunately our supply of dollars is based upon our current account deficit which will lessen at a much slower rate. For a period of time an imbalance and excess supply of dollars probably will be abroad and require a significant decline in our exchange values.

Representative WYLIE. I asked this question because back 3 or 4 years ago we were told that the high inflation, and the high inflation in which we have found ourselves, high interest rates and so forth, were in part due to the high price of oil.

Mr. Chimerine, would you care to comment on this question?

Mr. CHIMERINE. I think that is correct, Mr. Chairman. In fact, one of the reasons, although by no means the only reason, why the inflation rate has come down in recent years has been a more stable, in fact declining, price of oil. It has also been a significant factor in the economic recovery because it has helped push up real incomes in the United States. This reverses what happened during much of the 1970's when the sharp acceleration of inflation, in part because of double digit oil prices, began to cause a squeeze on household purchasing power and eventually was a major factor in that long period of recession and stagnation we had in the late 1970's and early 1980's.

So there is no question that it has been a beneficial factor.

I think the outlook for the price of oil depends heavily at this point on the OPEC countries. As you know, there is strong evidence to suggest that several of the OPEC countries have increased production in recent months, Nigeria being one, and there are several others. If they cut production back to their previous quota agreement, or even below—and I think the Saudis would have to be a major player in that—it is very likely we won't see too much additional erosion in prices. If they don't and continue to flood the market, particularly with demand still fairly sluggish, oil prices could edge lower.

Representative WYLIE. I don't know that there is a whole lot we can do about it.

Mr. Evans, would you factor that into your forecast for real growth in inflation?

Mr. EVANS. About a year ago I said I thought oil prices would drop from $29 to $25 a barrel—I still believe that is an accurate forecast—by the end of the year. I would be very surprised to see them go any lower. If they went to $15 a barrel, it would definitely be a two-edged sword. Our exports, of course, to OPEC countries

would drop off considerably. I wouldn't want to be seen alive in south Texas unless I was wearing a disguise. And the LDC problem would intensify unless there were a substantial decline in interest rates which went along with the oil prices.

We have had weakening commodity prices and short-term rates haven't gone down; long-term rates have come down a little bit.

It seems to me it would be necessary and appropriate if oil prices did drop to $15 a barrel, which I don't expect to happen, that we have a concomitant decline of 3 percent or 4 percent interest rates in order to relieve the burden of the LDC countries. Otherwise the international debt situation, I'm afraid, would become insurmountable.

Representative WYLIE. Mr. Fand.

Mr. FAND. I would be inclined to agree with most of what Michael Evans said, but I would like to make an additional statement. Obviously any change in the price of oil has important effects. If it goes up, it hurts us; if it goes down, it helps us. But I think the amount of effect tends to be overstated. I think we tended to blame too much of the inflation in the 1970's on the price of oil, and we may be giving too much of the credit for our strong recovery now on the drop in the price of oil, although I think it is helpful.

Representative WYLIE. Professor, you are from Detroit. We point to our economic recovery and say housing starts are up, real estate sales are up, automobile sales are up, all indications of optimism as far as the economy is concerned. What is your outlook for the automobile industry?

Mr. FAND. Most of the people that I have talked to in the automobile industry are very optimistic. The one thing they are worrying about are the wage negotiations later on this year. But so far as demand is concerned, they think we can have 2 or 3 very good years. In particular, in the State of Michigan the outlook is even a little better; that is, there is reason to believe that if the auto demand goes by x percent the demand for the kind of cars made in Michigan may go up 1.1 x, a little more than the average.

So I would say the outlook is very good, especially if we come out with a good settlement this August or September.

Representative WYLIE. Thank you.

Mr. Chimerine, in your testimony here before the Joint Economic Committee about 1 year ago you warned that a rapidly expanding economy would bring a credit crunch despite a reduced deficit. We have experienced phenomenal growth during the last year so far and into fiscal year 1984, and the deficit is still running about 10 percent. Is there enough to meet credit demands very nicely? Is that the shift? Or has your thinking changed since you testified before the Joint Economic Committee 1 year ago? How do you rationalize it?

Mr. CHIMERINE. Mr. Chairman, I don't recall using the term "credit crunch." What I think I did say was that the deficit outlook, combined with increased private borrowing, would eventually push interest rates significantly higher. And, no, my thinking hasn't changed, because by and large that is what is happening.

As I mentioned earlier, I think when you combine four factors, which I will review again in a moment, we are going to see additional increases in interest rates.

The four factors are, No. 1, continued large, and in fact growing, deficits in the next year or two.

Second, a continued rather rapid rate of increase in private borrowing.

Third, a continuation of the recent shift by the Federal Reserve toward a less accommodative posture. I don't think they will tighten enormously, and as a result I don't think we will have a severe recession, but I think they will gradually become less accommodative.

Fourth, and here is where I strongly agree with Alan Greenspan, at some point—I can't tell you when either—foreigners are going to become less willing and less able to keep accumulating the incredible amount of dollar assets that they have been accumulating during the past several years. They are going to start to need their savings to finance their own recovery. And, as Alan pointed out, at some point the amount of dollars they are willing to hold in any portfolio will reach its maximum.

Most importantly, if the dollar starts to weaken on foreign exchange markets, since it doesn't take too much of a decline in the dollar, or expected decline, to offset the added financial gain you get by holding dollar assets in terms of interest rate differential, this could even further reduce the willingness of foreigners to hold dollars. Again, in this kind of environment, with these large deficits and strong growth in credit demands, that would result in additional upward pressure on interest rates.

So I think the combination of those four factors, with the deficit being a major one, means even higher interest rates, and I think all that's happened is the kind of things we talked about 1 year ago have begun to develop even sooner than we anticipated.

Representative WYLIE. Mr. Evans, while we have been able to finance this strong economic expansion thus far with little upward pressure on interest rates, as you pointed out, I think thanks in part to good business cash flows and some internal financing, I'm concerned about the low level of savings rates in our society at the present time. Clearly we are now a consumption oriented society. Or at least today. Would you agree with that?

Mr. EVANS. Very definitely. In fact, I think the consumer spending has been one of the major factors that has pushed the economy up so high, and I think that part of the reason is that the interest rates paid by consumers has actually fallen over the last year.

We have also had a switch. I think a few years ago I might have expected that if the real after tax rate of return on personal savings rose as much as it has that the personal savings rate would also rise. But it hasn't. One of the reasons has been the tremendous amount of credit that the banks have made available. The dollar volume of credit card business grew 25 percent last year and is rising at a 30 percent to 35 percent annual rate this year. The banks have been very aggressive in marketing these. I don't know how many credit card applications I've received in the mail over the last 6 months. They seem to come every week.

The deregulation of the banking sector has caused the banks to make this credit available at reasonably attractive rates, and by that I mean the spread is much lower than it has been.

Also, consumers in many cases have a lot of catching up to do. Over the last 3 or 4 years the median family income in constant prices fell by about 10 percent and people are trying to catch up as the economy improves.

So I think all of these factors have contributed to the great growth in consumer spending, and as a result, the relatively low savings rate.

Representative WYLIE. Is the decrease in savings something that we need to be concerned about?

Mr. EVANS. I have been even more concerned about it in the past than I am now. It is something that I think needs to be encouraged through further action. The expansion of IRA's to include everybody, all employees, I think was a very good idea.

I still personally believe that when the revised figures come out they are going to show more savings than have been reported, although I obviously can't prove that. But I think further incentives to individuals to save, such as we find in every other industrialized country in the world, are still something that is important and should be pursued.

Representative WYLIE. Thank you very much. My time has expired. I have given us each 10 minutes. So I will let you go now, Congressman Scheuer, if you would like.

Representative SCHEUER. Thank you.

I would like to ask the whole panel the question that Alan Greenspan and I were discussing, namely, how would the financial markets, both at home and abroad, react if the President's advisers get in and make a flat commitment not to have any tax increase whatsoever next year? What would happen to interest rates? Would there be a threat of possible disinvestment by foreign investors? What would be the impact on their confidence in the integrity of the American financial community, American markets?

Give me sort of a James Joycean stream of consciousness.

Mr. CHIMERINE. I will take a shot at that, Congressman.

I think it would be negative, although I am not sure it would push interest rates up any higher than they already are by itself, because I think the markets expect that. I think the reaction would not be positive primarily because I think the financial markets believe, as I do, that you cannot adopt satisfactory measures to produce a downward trend in future deficits without some tax increases. It is virtually impossible to do it on the spending side alone, even if you make cuts in the entitlement programs, which I would endorse, because any changes would have very limited effects on spending in the first several years. They might accumulate down the road, but in the first 5 to 6 years they are likely to be very small. Also, the military buildup is virtually in place already. It will be very difficult to make sizable cuts. And nobody is arguing for additional cuts in the non-means-tested, nonentitlement social programs.

I think the markets believe that it is therefore virtually impossible to reduce future deficits to acceptable levels without some tax increases, and I think a direct statement that there would not be any such tax increases would have a negative effect.

Mr. RATAJCZAK. If I can comment on the interest rates. First of all, I agree with that. The markets are anticipating not a signifi-

cant effort to reduce the deficit, and therefore interest would not go appreciably higher, but obviously it would have an adverse effect upon the financial markets.

I think, however, there is another assumption that is coming forward, which is that the financial markets respond favorably and therefore the economy will respond favorably. As we have seen with the sharp increase in deficits in the past couple of years, these gave us initial significant economic stimulus, and we are now concerned, as Mr. Chimerine said, about the out years.

Well, it does work in reverse, too. If we significantly close the budgetary gap, the initial effect will be adverse to the economy; the stimulus that we will get as a result of declining interest rates will come somewhat later; and indeed, if it is viewed, as in some circles it could be, that the degree of economic slowing is quite substantial, it is possible that we will be adding rather than subtracting from the long-term stock of bonds that the Government will have outstanding as a result of reduced economic growth.

I really very much think that the Congress has to be more aware of where we are in the business cycle when they make these decisions about multiyear tax cuts or multiyear tax changes and where we are in the business cycle when they start to address the structural deficit problem. Nineteen eighty-five is not the year that this problem should be aggressively addressed.

Representative SCHEUER. Mr. Ratajczak, if 1984 isn't the year——

Mr. RATAJCZAK. Eighty-four was the year.

Representative SCHEUER [continuing]. Maybe it was as a theoretical matter, but as of midnight December 31 it became a nonyear for major political risk taking for both of the two major parties. That is the fact of life. I'm not going to say that my party is any more courageous or noble than the other great party. The fact of life is we don't accomplish much in the way of major risk taking initiatives in 1 year out of 4. You can say that democracy is the worst possible form of government, as Winston Churchill once said, except for all those other forms of government. One weakness of our form of government is we don't accomplish a helluva lot 1 year out 4; we sort of tread water.

Now if this year isn't the right year to do it and next year isn't the right year to do it, when is the right year to do it? How long can we afford to wait before really biting the bullet and getting together and pulling in our belts a couple of notches and doing what has to be done, let's face it, for America, the America that we know, the free enterprise system?

Mr. RATAJCZAK. I agree that the long-term problems are quite significant, and that is what we really do have to address. It may very well be that we are willing to accept the costs of addressing the problem next year with the high probability that the method of addressing the problem, if it is aggressive and will ultimately be successful, will lead to an economic downturn in 1986. If it is well understood that that will occur and that, indeed, the improvement in the financial markets simply do not work through the system that rapidly to buttress the economy and prevent it from an economic downturn, then I would recognize that that would be the way to approach the problem.

Representative SCHEUER. Why do you have so little confidence in your profession that the four men remaining at the table couldn't come up with a program, a balanced, thoughtful program of fiscal and monetary, tax, spending, budget reduction and other measures that would phase us in, not in an explosive leap into the unknown, but phase us in by prudent, rational steps into a period of noninflationary sustained growth and fiscal stability and sanity?

It seems to me the big question is not whether you could design it, but whether his party and my party can do it and whether we can get a President to sign it. It seems to me it is political guts that is lacking, not economic professionalism.

Mr. RATAJCZAK. I agree with you that that would be the type of package that would be most prudent, one that brings us over a period of several years into a convergence on budget balance. The problem is that no one will believe that kind of a package.

Representative SCHEUER. They wouldn't believe it?

Mr. RATAJCZAK. I really think there is a huge amount of skepticism in the marketplace.

Representative SCHEUER. Well, there is now because, as you say, Congress hasn't acted, and we could have acted in 1983. We should have known in 1983 that we weren't going to do much in 1984, and we should have done then what we haven't in 1983 or 1984. It seems to me by the time we get to 1985 we have really got to bite the bullet and do what is necessary.

Mr. CHIMERINE. Congressman, can I add something to my previous response, and in fact, to some of the comments made by Mr. Ratajczak?

Representative SCHEUER. Sure.

Mr. CHIMERINE. I strongly disagree with the essence of his remarks that we shouldn't take action to reduce deficits in 1985. Actually, I think we should take it right now. I disagree for two reasons. First of all, cutting back future deficits on a gradual basis will not eliminate all the fiscal stimulus; there will still be ample fiscal stimulus to promote additional economic growth.

Second, the benefits to the economy that would result from a sharp decline in interest rates, from a more fairly priced dollar on foreign exchange markets, for better prospects for foreign trade, for an easing of the LDC debt crisis, and all the other benefits, would cause the economy to do much, much better even with lower deficits. There would still be a fair amount of fiscal stimulus and lower interest rates at the same time. There is no evidence to suggest that these kinds of actions would produce a recession. Quite the contrary, I think without these actions, we are more likely to have a recession during the next several years.

On the other issue, anyone of us here can come forth with 15 different packages to reduce deficits. I think the big problem, quite frankly, is not the absence of options, nor even the election. I think it is what the chairman referred to earlier. It's the differences in viewpoints and priorities among the key people involved in the decision making process. The President doesn't want to cut defense. He says he doesn't want to raise taxes. Nobody wants to cut some of the social programs.Now strong supporters of the entitlement programs have popped up and the administration itself is recom-

mending adding spending to social security, which it didn't have to do.

The real problem is reaching a consensus. There are many, many different options. I am somewhat concerned, because I don't think it is going to be quite so easy after the election to reach consensus in view of the different viewpoints that exist.

Representative SCHEUER. Mr. Evans.

Mr. EVANS. Mr. Scheuer, let me go back and answer your original question, which is still very relevant, even though we have some interruptions here, which is how would the financial markets react if the President made a flat-out statement no tax increase.

Representative SCHEUER. Right.

Mr. EVANS. Let me go back to 1968.

Representative SCHEUER. No tax increase in 1985.

Mr. EVANS. Let me go back to 1968 where there were a bunch of economists sitting around a table just like this, except they are all older now. Ninety percent of the economists agreed that what we needed was a surcharge because government spending was growing too fast, the economy was overheating. If we had a surcharge, we were told, we would have a balanced budget next year, we would have lower interest rates, we would have lower inflation, and we would have continuation of the recovery, of the boom.

What actually happened is we got the balanced budget all right. In fact 1969 was the last year that we ever had a surplus in the Federal Government. But inflation went up from 4 percent to 6 percent, the prime rate and other interest rates went up from 6 percent to 8½ percent, and the economy was plunged into a recession in late 1969, the first recession we had had in almost a decade.

Obviously something went wrong. The surcharge was not the correct medicine. I think the surcharge is just as bad an idea now as it was then.

So therefore if the President said we are going to have no tax increases at all in 1985 I don't necessarily think the financial market reaction would be bad. It depends on what else he said in the message. I doubt that the President would issue a one-sentence message; actually he would probably have something else to say.

But now we get to the second part of your question, how do we fix the problem?

Alan Greenspan was perhaps being overly modest when he said it is not an economist's place in life to make policy suggestions. I make them all the time. I don't know what that means.

I think that what we need to do is we need to get the deficit down, but without doing the sorts of things that are going to retard productivity, that are going to raise costs. And that is why I believe that tax reform is the best way to go, the modified flat tax proposal, and I think that this will raise revenue. And, by the way, it will raise the average tax burden of the American family. There is no free lunch here. It is ridiculous to get up on the floor of the House and Senate and say "my tax reform bill will raise revenues, but 70 percent or 80 percent or 90 percent of the American people will pay less taxes." That's nonsense. You may as well walk away if the guy is going to tell you that. It will raise taxes.

On the other hand, by lowering the high marginal tax rates, which are having an increasingly serious effect on diverting money

into tax shelters—we had between a 50 percent and 100 percent increase in tax shelters last year, and I know that the Congress has done something about reform. But unfortunately, whereas they closed loophole A and loophole B, they just pushed everybody into tax shelter C. I think that is a fact of life.

We need to do something, in my view, to reduce the marginal rates but raise the average rates, and that, I think, will reduce the deficit. In my personal opinion, the financial markets would react very positively to that kind of suggestion, if it were passed.

Representative SCHEUER. Let me ask one last question that you can have some fun kicking around, the question of a constitutional amendment on the balanced budget.

We tend around here to react to that on sort of a knee-jerk basis: Democrats tend to react against it; Republicans tend to react for it. We are as one in our keen desire to begin to really hone in on a balanced budget. Does the concept of a constitutional amendment requiring a balanced budget play any role, any useful, positive role? Does it hold out any hope? Is it a useful symbolic thing?

It's not the reality of actually going to work with a sharp pencil and making the painful cuts that we know are coming and that lie there down the pike and that we have to face up to. It is a symbolic thing. But maybe we need the symbolism as well as the sharp pencil.

What are your reactions as to the usefulness of a national dialog and a further congressional dialog on the question of the constitutional amendment on a balanced budget?

Mr. FAND. I think that is a very good question, and I would like to consider it in connection with your previous question. I think if we continue with the ordinary ways of dealing with the deficit it is not going to work. If we say we are not going to raise taxes, some people are going to take that as bad news; if we say we are going to raise taxes, other people will take that as bad news. I think we have to do something a little different now. And while I believe that it would be a mistake to raise taxes, if the increase in taxes now came in a way where if God came down and convinced the American public that that increase in taxes will not be used to let expenditures continue running away, it could be productive.

So I think we have to do something very dramatic now to convince the public that we are not going to continue the old business of just letting revenues finance more expenditures. If that can be done, I think it would be productive.

Representative SCHEUER. Anybody else?

Mr. CHIMERINE. I would strongly agree with that, and, in fact, also with my old friend on my right, that the increase in taxes should be something along the lines of Bradley-Gephardt, or something that raises average tax rates, but not marginal rates. But that is an issue of how we raise the revenues, not whether or not we need higher revenues.

I think it is important that any package you put together do two things. First of all, on the spending side it clearly should include specific actions that will produce the lower spending that the Congress wants, or the ceilings that are embedded in those spending targets. Just to say we are going to cut military spending growth to 4 percent a year in real terms without taking any action on the

specific weapons systems doesn't convince the markets, because unless the weapons systems are reduced, or some other cuts are specified, the markets will not believe the actual cuts will take place.

So it is most important that you first cut spending as much as you can and take the appropriate actions to ensure that those spending cutbacks will materialize.

Then, second, the gap will have to be make up on the revenue side. I strongly agree with Michael that the way to do it on the revenue side is to broaden the tax base. Somebody will pay more, but without raising marginal tax rates.

Representative SCHEUER. Without raising tax rates?

Mr. CHIMERINE. Without raising marginal tax rates. Do it by broadening the tax base, by eliminating various kinds of deductions, or tax shelters, or loopholes, whatever. If it is done that way and the specific actions are set forth, that kind of package would be very acceptable and very convincing to the markets. And I think you can do that without a constitutional amendment to balance the budget.

Mr. RATAJCZAK. There is a broad question, which is what is Government doing currently that is inappropriate, what spending is wrong.

I really do think the defense budget has not slowed as much as the underlying inflationary indexes in the defense categories. We should have received more relief from reduced inflation in that area. Aside from that, it is very hard to make the argument as to which spending is wrong.

And then the other issue on the taxes, to say let's broaden the tax base. While I think it is useful to say definitely we will get some incentives by lowering marginal tax rates and movement toward a flatter structure might be very helpful, obviously all those what we call tax/expenditure items at the present time also have incentive effects.

One of the reasons why we cannot resolve this question is we can pass all the broad-based statements that we want, that we want to slow down the growth of Government, that we want a balanced budget, that we want to get certain financing, but no one wants to get into the specifics and say that it is more wrong to have higher marginal tax rates than to have a 15- or an 18-year depreciation on rental property. Until we get to that degree of specifics, I really think that we are playing around with symbolism, and symbolism in the Constitution bothers me a great deal. It is a wonderful instrument, and I would hate to have a constitutional amendment that the first thing we do after we pass is to find ways to subvert it. Quite frankly, I think that will be the result of a balanced budget constitutional amendment.

Representative SCHEUER. Thank you, Mr. Chairman.

Representative WYLIE. Thank you, Congressman Scheuer. I am pleased to hear the answers to that question. I think it is one that is going to come again and again between now and November.

Mr. Evans, in your prepared statement you say economists of virtually all stripes have been captive to the outmoded domestic paradigm that rapid growth must necessarily worsen inflation. Do you find that in your testimony?

Mr. EVANS. Yes.

Representative WYLIE. This certainly has not been true over the last 18 months, has it?

Mr. EVANS. Well, no, the whole situation has changed. We've had very rapid growth and yet inflation has not only been stable, it is actually lower than it was almost at the beginning of the recovery. I think the major reasons this has occurred are the sustained gains in productivity, also the fact that the United States is a more open economy, and that we have countervailing power from imports, and I expect that these factors will continue for several years. So I don't think we are going to have a rise in inflation like we usually do.

Representative WYLIE. You do expect it will continue for some time to come?

Mr. EVANS. Yes, I do.

Representative WYLIE. As a Fed watcher, and there are many more of us nowadays, it seems like, would you say that a large segment of the Federal Reserve's Open Market Committee tends to equate fast growth with inflation? In general, what is your assessment, then, of how the Federal Reserve is handling its so-called high-wire act of walking between inflation on the one side and recession on the other? I think you did comment some on that a little earlier. But again, we want to get specifics.

Mr. EVANS. I think for many years members of the Fed did believe that there was probably a 6- to 7-quarter lag between the time that money supply changed directions and inflation changed directions. We had a very rapid growth in money supply between June 1982 and June 1983; it grew 13 percent. So there is a lot of worry among members of the Fed that perhaps they had overdone it and that we would pay the price in terms of higher inflation later this year.

I think they are just now beginning to accept the fact that inflation need not be part of the problem. I think their attitudes have probably changed considerably over the last 3 months alone, and I think that now they are very happy with the unit labor costs that came out; they are, of course, pleased with the general deflationary trend in commodities.

I don't think they have all been convinced yet. I would say if we could continue to have rapid growth and declining inflation for another 6 months, I think many more Fed members would be convinced than are right now.

Representative WYLIE. Do you want to comment on that, Mr. Fand?

Mr. FAND. I think on the whole, the Fed has done a very good job. I think that the mechanism we now have is that the aggregate supply function to the American economy is now relatively elastic because it is being augmented by foreign capacity, and therefore we have the wonderful result that output can expand at a rapid rate and we have declining inflation. I do think that the Federal Reserve was on to this, and I think their policies have been accommodative. They have not done anything to hurt this recovery. I think that they have done an outstanding job and I think they clearly understand the mechanism of why we are having such wonderful results right now.

Representative WYLIE. Thank you.

Mr. Chimerine, I want to pin down something with you here, if I may. As my staff and I read your prepared statement we noted that you have painted a rather pessimistic scenario, as I mentioned earlier when I went to the next witness. As an example, let me quote the first two sentences in five of the summary statements in your prepared statement. It says, "The recovery process is likely to flatten out during the course of 1985, with little or no increase in GNP expected during the course of the year. Furthermore, it is also possible that this slowdown will actually deteriorate into a full-fledge recession."

As we observed the forecast summary table attached to your prepared statement we felt a little better. Although you forecast a 3-percentage point rise in interest rates in 1985 and a slowdown in GNP and other economic measures, I don't see any recession reflected in your table. You certainly are optimistic about the unemployment rate and you are optimistic about inflation. So as I say, I felt better as I read your table, better than I did as I read your prepared statement.

Which reflects the true Lawrence Chimerine?

Mr. CHIMERINE. Both. Or maybe neither.

Actually there are two points to be made, Mr. Chairman.

First of all, the numbers you see reflect the forecast which has the economy flattening out. I think that is the most likely outcome. I think that a recession could occur, but I don't think it is the most likely occurrence.

Second, the tables show year-to-year numbers, which tend to be distorted by the starting point. A better way of looking at it might be to look at some of the graphs which follow. If you look at real GNP growth you will see for each of the four quarters of 1985 either zero or very small positive numbers. So if you look at it during the course of the year, on a fourth-quarter-to-fourth-quarter basis, which is not the way the table shows it, you would see very little growth, something like 1 percent or 2 percent. On a year-over-year basis, it is considerably more than that, reflecting the growth we are having during the course of 1984 and the high starting point.

I would like to make a third point, if I can, Mr. Chairman. Sometimes words can make things seem more pessimistic than the numbers might suggest. Again, if these numbers turn out to be correct, I wouldn't call this an impending disaster. It is that the economy is tending to flatten out at a reasonably high level; it means a small increase in unemployment during the course of 1985. But by no means is it a repeat of 1981–82 or 1974–75; it simply means that in my judgment, given some of the underlying problems we have, the kind of growth pattern we have had over the last 18 months will not be sustained in 1985, although we most likely will avoid a sharp decline in the economy.

Mr. FAND. May I add a comment to his answer?

Representative WYLIE. Yes.

Mr. FAND. I believe that the recovery could go to 1987, but even if we accept Larry's diagnoses here, this would still be an average recovery; that is, it would be a recovery that lasted roughly 3

years. So as you say, it is not a disaster. But I think we will do better than that.

Representative WYLIE. Thank you.

Mr. Ratajczak, in your prepared statment you estimate that the natural rate of unemployment is slightly more than 6 percent. We are now at 7 percent, following employment growth the past 18 months, and that has astounded economists as well as policymakers. Apparently we still have some room to grow. What unemployment rate do you project for, say, October of this year, to be announced on November 2d, just before the Tuesday you know what? Do you see that natural rate of unemployment rising as it has in the past few decades, falling, or remaining about the same over the next 10 years?

Mr. RATAJCZAK. I think we are past the period of rising natural rates and are in fact moving into the period of declining natural rates. We in fact would have argued the natural rate was about 6.5 percent in 1982 and that we are now moving down to the vicinity of 6 percent. I see no reason why we would not have that rate down to the vicinity of 5 percent by the end of the decade. So that in fact we are getting somewhat greater room to grow in the labor markets than we have in the past.

Now to the specific question, the November 2. That's a hard one to call. At the present time I think there is a possibility that we may actually see one or two up-ticks in unemployment, not because there is any dramatic weakening in the overall economy, but rather that the household survey showed a seven-tenths of a percentage point decline in unemployment rates in the last 2 months while the insured unemployment rate only showed a one-tenth decline. This is an unusual discrepancy between the two series, and I feel fairly comfortable about the insured unemployment figures. So as a result, if Janet Norwood comes before this committee tomorrow and explains a slight up-tick in the unemployment, I would not be surprised.

But having said that, basically that would mean only that we are not going to drop as rapidly, I believe, as Mike is pointing out, but once we get that adjustment in the data out of the way the decline will continue and will probably be somewhere in the 6.5 percent or 6.6 percent rate during that period of time.

Mr. EVANS. I need to clarify one point here about Don's confusion. This may sound like a technical point, but acutally it is not. He points out that the household survey rate fell sharply in the last 2 months and the insured rate remained stable. That is obviously what happened. The insured rate isn't a very good rate anymore, and there is a very important reason for that, and that is that most of the jobs that are being created, the 7 million jobs that have been created in the last 18 months, are outside of the standard sector of the economy. In other words, they are new industries.

You may want to ask Janet Norwood about this.

The survey simply can't keep up with all these new industries and all these new entrepreneurs that are creating jobs, and that is where the big increase has come. And so as a result the insured employment, which used to be a very good indicator of what unemployment is going to do, turns out to be a crummy indicator these days. And so as a result, I think we are going to see the overall

unemployment rate fall a lot more sharply than is indicated by the ensured, and that is how we get those numbers down that low, Don. I would say the October rate probably could be 6.2 percent, could even, with a little bit of luck and reverse English on the ball, be 6 percent. But I am not saying quite that.

Representative WYLIE. Well, I hope you are right. We will wait and see. It won't be long until we know, will it?

Mr. EVANS. That's right.

Representative WYLIE. Mr. Fand, from your statement it doesn't seem that you are terribly concerned about the inflation outlook. You say that we may be in for a rare period of rapid economic growth along with low inflation. Could we be entering a new economic era, as Secretary Regan said when he appeared before the Joint Economic Committee recently?

Mr. FAND. We could, depending on how wisely we manage policy. I think, obviously, we have been doing something right. We have a strong investment boom going on; we have rapid economic growth; we have declining inflation. We are doing something right. I think if we keep that up—and we can discuss a little more what we mean by keeping that up—I think it could last and it could be a new era.

I also think that ultimately we want to do something about savings. I think one of the reasons we have a large trade deficit now is our investment demands are much too large for our savings, and I think that has something to do with the double taxation of savings. There is some need for reform in that area.

So as long as we have the existing laws and our investment demands are running so much ahead of our savings, the only way we can do it is through the trade deficit.

But I think we could be at the beginning of a new era if we manage policy correctly now.

Representative WYLIE. Thank you very much.

Mr. CHIMERINE. Congressman, can I respond to that very briefly?

Representative WYLIE. Of course.

Mr. CHIMERINE. I would make a cautionary comment. I can remember back in the autumn of 1982 when the recession that was underway at that time, as you know, was much longer lasting and much deeper than most people had anticipated. More and more people were beginning to talk about a new era of permanent stagnation in the United States—maybe we will never get an economic recovery which became a popular refrain. I think one of the biggest dangers that people potentially are making right now is extrapolating what has happened over the last 18 months and assuming that this is the wave of the next 50 years in the United States. This is just as dangerous as the extrapolation in 1982, particularly in view of some of the problems that exist.

With respect to inflation, there is no question there has been a permanent improvement in the long-term inflation outlook, partly reflecting somewhat better productivity growth; partly reflecting a very competitive environment, due in part to deregulation in a number of industries, which has made them more competitive; partly because the Fed is more conscious of inflation than it was before. But by the same token, a lot of the factors that are holding down the inflation rate now are also somewhat temporary. Eventually, food prices are going to start rising, and oil prices will start

rising later in the decade. The dollar at some point will have to come down. We won't have an industrial sector left if it doesn't. That will mean more inflation.

So I think you have got to be very, very careful in talking about a new era, simply because we've had a few months or even a year of change. It is important to look at some of the underlying forces, and I don't think they suggest all that rosy of an outlook.

In most ways it's a lot better than we had in the 1970's, certainly with respect to productivity, inflation, and maybe even long-term growth prospects, but not to the extent that I think we are hearing from certain people.

Representative WYLIE. You are pointing up our dilemma. Thank you.

Congressman Scheuer.

Representative SCHEUER. I have observed as a sort of horseback people's economist that over the course of several administrations of both parties we really—I want to echo what Mr. Greenspan said—haven't fine-tuned our fiscal and financial, tax credit and other policies really to guide the economy very, very well. I sometimes wonder whether we are at the tiller of the economic ship of state, charting our course through these heavy seas, or whether we are in some kind of a rowboat out there being tossed about by elements that we have no control over, that we have very little comprehension of, and we are desperately trying to hold on to the tiller with one hand and prevent the sails and the mast from being blown off with the other.

Is this recovery something that is happening because of our administration or in spite of it? Did we get into the recession that preceded it because of an administration or in spite of it? What is the degree of controls that we have? What is the efficacy of our fiscal and monetary and tax fine-tuning controls that we really can hope to guide our economy in any effective way over the long pull?

Mr. EVANS. I think that fine-tuning is an idea whose time has passed. We tried it in the 1960's. We ended up in a recession. We got out of it. We ended up in a worse recession, and so forth.

I would like to suggest that the concept of what I would call broad tuning still makes sense. What I mean by that is trying to maintain some level of economic activity over a business cycle average. I don't think we can ever do away with business cycles entirely, although they have been a lot worse recently than they have to be.

But the idea that if we somehow press the magic buttons we could have 4 percent growth and stable inflation forever is something that I just can't accept. I think we need to broaden the economy, and we should have learned by now that if we keep on pumping up fiscal stimulus and the monetary authorities are accommodative and we do this for long enough, eventually it is going to be inflationary. I don't know any theory of economics that disagrees with that. We tried it for 20 years, and we got about what we deserved.

So I think if we could broad-tune the economy and try to relate to business cycle averages, fiscal and monetary policy can be very useful.

Representative SCHEUER. You left out tax policy.

Mr. EVANS. Fiscal policy, I should have said, includes both spending and taxes. Tax policy is critical, I agree. My point was that trying to adjust with either spending, taxes, or monetary policy to try and affect something that is going to happen 6 to 9 months in the future has never worked and I certainly don't think it going to work in the future.

Mr. CHIMERINE. I think, Congressman, that the No. 1 priority of the Congress and the administration in terms of economic policy is to make sure that they remove any obstacles in the way of a satisfactory performance of the economy. Right now, that means strong action to reduce deficits, because I think it is clear that eventually we are going to have some problems as a result of this incredible Federal debt.

But I agree with Michael. Beyond that, in terms of precise fine-tuning, and should you slightly manipulate this tax rate or this tax credit, more than likely those have a much smaller impact on the economy than some people would expect. But certainly it is most important that, from a policy standpoint, no major obstacles, either in the way of excessive money growth or excessive deficits or whatever, be placed in the way of the economy that could jeopardize satisfactory performance.

Mr. RATAJCZAK. I don't disagree with the other two statements, although I would like to address the question about the recession and the recovery. I think you can trace policy programs. Certainly the Federal Reserve programs, which I view, by the way, to be very appropriate, as part of the factors leading to that recession and the duration and depth of it, and that the tax package, while it might have had some adverse initial effects—I still think a 3-year scheduled tax reduction is not the way to change taxes, because it causes people to shift behavior from one year to the next, and I believe that that program initially exacerbated the recession and then stimulated the recovery after all the shifting had taken place toward the end of all the marginal tax rate reductions.

So, in fact, I think the instability of both bad and good in the economy of the last 3 years is fairly closely related to the policy moves that have been taking place.

Representative SCHEUER. One last question, if I may.

One thing that we can control is trade policy, and one problem that we can look at is the incredible, the tragic impact on our ability to sell goods and services overseas by what has been characterized as the overvaluation of the dollar. Of course it's not an overvaluation of the dollar at all; it is how the international market values the dollar in relationship to other countries. We Democrats believe in the play of free market forces, as everybody knows.

Representative WYLIE. Some Republicans do, too. [Laughter.]

Representative SCHEUER. And it ain't overvaluation or undervaluation; it's valuation. When the dollar becomes inordinately expensive in terms of other currencies it's great for the American tourist overseas, but it is bloody unshirted hell for the manufacturer or the purveyor of services around the world, and that is hurting America very badly.

What kind of intervention do you think we are capable of broad turning, let us say, following your phraseology, Mr. Evans? What kind of intervention should we attempt to broad tune to set into

effect a few little ameliorative forces or currents in that ocean that would gradually give the market some damn good reasons to value the dollar in relationship to all of these other currencies at a level which would give our domestic manufacturing industry, which we have to preserve, we want to preserve, and we want to make competitive in global commerce, a chance to make it in commerce overseas? That's a tough question.

Mr. CHIMERINE. I think, Congressman, fundamentally there is one thing you can do: Take credible action to reduce deficits. Because in my view, and I feel quite strongly about this, the No. 1 reason why the dollar is so excessively strong is because of the deficit and its impact on financial markets in the United States. We need a substantial amount of foreign money flowing into the United States to help finance, either directly or indirectly, the deficit. In my judgment, we won't see a full and necessary adjustment to the dollar on foreign exchange markets until the markets see credible action to reduce deficits and feel confident that interest rates are reduced on a permanent basis.

Representative SCHEUER. Mr. Chairman, thank you very much.

Representative WYLIE. Thank you very much, Congressman Scheuer.

Representative SCHEUER. I want to thank the panel. It has been very enlightening.

Representative WYLIE. Indeed it has.

Gentlemen, we really do appreciate your appearance here this morning. You have proven to be an outstanding panel, as Congressman Scheuer has said, as I know you would. We thank you for taking your extremely valuable time to be with us this morning to help us in our deliberations.

The Joint Economic Committee stands adjourned.

[Whereupon, at 12 noon, the committee adjourned, subject to the call of the Chair.]

THE 1984 MIDYEAR ECONOMIC OUTLOOK

FRIDAY, AUGUST 3, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-106, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen and Proxmire; and Representative Hawkins.

Also present: Dan C. Roberts, executive director; James K. Galbraith, deputy director; Charles H. Bradford, assistant director; and Deborah Clay-Mendez and Mary E. Eccles, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Good morning, Ms. Norwood. Welcome, Senator Proxmire and Congressman Hawkins.

Madam Commissioner, the outstanding performance of the American economy over the last past 20 months is a clear and convincing demonstration of the success of President Reagan's economic policies. Under President Reagan's leadership we have sought to reduce the burden of Government regulation and to free the powerful forces of private enterprise and competition. The success of this policy is there for all Americans to see, and the prosperity that it brings is for all Americans to share in. The overall civilian unemployment rate has fallen from 10.7 percent in November 1982 to 7.5 percent in July of this year, based on the figures you report today. During the past 20 months, civilian employment has increased by a recordbreaking 6.4 million.

Ms. Norwood, because of the problems associated with seasonal adjustment at this time of year, we recognize that the July employment figures you bring today cannot be interpreted in isolation, but must be viewed together with the May and June figures. The positive trend in labor market conditions over this period is unmistakable. I am pleased to see that employment, as measured by the establishment survey, continued to increase in July and that the diffusion index continues to indicate employment growth across a range of industries. As I understand that, to paraphrase it, people meeting payroll said they increased their employment, and those surveyed in households, which is what your survey is based on, said that they were having a more difficult time finding jobs or there were more of them that could not find jobs. That's the premise it's based on.

Economists are now revising their forecasts of the 1984 gross national product upward, while revising downward their projections of the 1984 national deficit. Yet, it is no wonder that their projections have been faulty. Projections are based on the performance of the economy during previous economic expansions, and during the past six quarters our economy has grown more rapidly than at any time since 1949.

Both this rapid economic growth and the continued, widespread improvement in labor market conditions have been achieved without a resurgence of the devastating double-digit inflation to which Americans were subjected only a few short years ago. And I understand from the report today that the inflation mark is still a very healthy and good one. Under the current administration, economics is no longer a zero-sum game.

Before you is a chart over here on my right and on your left comparing the sum of today's inflation and unemployment rates—the so-called misery index—to the levels prevailing during previous years. As you can see, the misery index now stands at approximately half of its 1979 level.

Madam Commissioner, let me welcome you once more to the Joint Economic Committee's monthly hearing on labor market conditions and consumer prices. And I will now yield to Senator Proxmire for any opening remarks he may have.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you very much, Mr. Chairman.

No matter how you look at it, the figures for July are not good. I think we can say that they are about the same as they were in May. We were so happy about what happened in June when unemployment seemed to drop sharply, four-tenths of a percent, which is a big drop in a month; but they went right back up four-tenths of a percent in July, wiping out what looked like a real advance.

We have a situation where in the last 2 months, at best, unemployment has been stable and has not improved. We still have 8.5 million Americans out of work and no improvement really overall net in the last 2 months.

It's true that there were seasonal factors that distort it, as some of us tried to point out in June, and there may be seasonal factors that may well be distorting it, as you point out, for this past month for July. But there are certain underlying problems that look serious.

Single family housing starts are down. New claims for unemployment compensation are up. New factory orders are down, the drop that you describe, while it is not reflected in the establishment survey, is in the most comprehensive survey that we have or any other government or any other private agency has. When you talk about polls. This is a poll of 60,000 individual families. Is that right, Ms. Norwood?

Ms. NORWOOD. Yes, sir.

Senator PROXMIRE. Which suggests that it reflects a very, very accurate figure. As we know, the leading indicators fell in June for the first time in 22 months. So it looks as if the recovery may be slowing down and coming to a halt and the stock market seems to

think that's a good idea. On the other hand, as I say, we still have 8.5 million Americans out of work. We have a substantial increase in black unemployment particularly, although in almost every other area I notice unemployment increased according to your survey.

Thank you, Mr. Chairman. I will have some questions.

Senator JEPSEN. Congressman Hawkins.

Representative HAWKINS. I have nothing at this time. I'd like to hear Ms. Norwood explain this phenomena and also listen rather carefully to the President and some of the others explain the rest of the day and this weekend this beguiling phenomena which seems to have occurred that has never yet been explained I think by other than seasonal factors. But I look forward to the testimony of Ms. Norwood.

Senator JESPEN. Ms. Norwood, welcome again. You may proceed with your testimony.

STATEMENT OF HON. JANET L. NORWOOD, COMMISSIONER, BUREAU OF LABOR STATISTICS, DEPARTMENT OF LABOR, ACCOMPANIED BY THOMAS J. PLEWES, ASSISTANT COMMISSIONER, OFFICE OF EMPLOYMENT STRUCTURE AND TRENDS; AND KENNETH DALTON, ASSOCIATE COMMISSIONER, OFFICE OF PRICES AND LIVING CONDITIONS

Ms. NORWOOD. Thank you very much. Mr. Chairman and members of the committee, I am, of course, always very pleased to be here to try to add a few comments to the employment situation release issued this morning by the Bureau of Labor Statistics.

The July data are difficult to interpret. The business survey shows that jobs rose by 300,000 from June to July after seasonal adjustment, and the household survey shows a drop in employment of 350,000. As reported in the household survey, both the overall unemployment rate and civilian unemployment rate returned to their May levels—7.4 percent and 7.5 percent respectively.

These are clearly not a consistent set of data for evaluation of current labor market trends. What do they really mean? Let us examine the details.

First, the household survey. As I suggested to you last month, sharp seasonal swings occur in household survey data in the summer because employment expands at this time each year. But the exact timing of the increase during the summer varies from 1 year to the next. From June to July this year, employment in the household survey rose by 670,000 before seasonal adjustment, and from May to June it had increased by 1.7 million. In July, after seasonal adjustment, employment declined by 350,000. Seasonal adjustment, a statistical process designed to remove the regular variations which occur at the same time each year, is especially difficult during these summer months. It is further complicated this year by the unusually strong recovery which began at the end of 1982.

I believe that the very strong recovery and an unusually large employment growth in June and July of 1983—which had considerable weight in the seasonal adjustment process—may have caused the seasonal adjustment process to overcompensate for the changes

this summer. In 1984, the total actual summertime expansion in employment—from April to July—was very large, nearly 3.9 million, but the job increase took place quite early. The increase taking place in July was only 17 percent of the total April-July change—that is over the summer—in contrast to last year when the July proportion was twice as large.

Mr. Chairman, attached to this statement is a table which shows those changes and which shows the proportion of the summer change in growth in employment that occurred in July. If you look at column three, you will see that the only other year that was at all like 1984 is 1978 and that we have basically a very much smaller change in employment occurring in July this year than in the preceding years since 1978.

The volatility of these numbers has, of course, also affected the unemployment rates registered during the summer months. That is, both the June decline and the July increase in the unemployment rate may have been overstated. Jobless rates for most worker groups in July, however, were the same as or lower than they were in April. As we move further through the summer, we will have more data and the situation should become clearer.

Now let's look at the business survey. Conceptual and measurement differences make the business survey less affected than the household survey by seasonal adjustment problems in the summer months. In addition, sampling and estimation procedures make the monthly estimates from the business survey less volatile than those from the household survey. From June to July, employment as measured by the survey of business establishments increased by 300,000 after seasonal adjustment. The July data showed continued strength in manufacturing—which rose by 105,000—especially in fabricated metals, machinery, and electrical and electronic equipment. Employment in nondurable goods also advanced. Construction added 30,000 jobs and the services industry 40,000. In all, two-thirds of the industries covered in our diffusion index are still showing over-the-month gains. In addition, the factory workweek remained at a very high level.

Where does this leave us? The business survey shows continued employment growth. Employment as measured in the household survey has returned to the May level, but the July figure is still 1 million above the April level. Estimates from the household survey often have large movements in a single month that can be better understood by looking at data over a longer period. Over the last year, employment growth in both surveys has been close to 4.2 million.

In summary, I think that there continue to be some indications of improvement in the labor market, even though there are some confusing signals this month. I expect that, as the data for the next few months become available, we will have a better understanding of labor market developments over the summer.

Mr. Chairman, as is our usual custom, I have helping me this morning Mr. Plewes on my left, who is our labor force and labor market expert; and Mr. Dalton on my right, who is our price expert. And the three of us now would be glad to try to answer any questions you may have.

[The tables and chart attached to Ms. Norwood's statement, together with the press release referred to, follow:]

Summer employment changes
(Numbers in thousands)

Year	Not seasonally adjusted			Seasonally adjusted	
	(1) June-July	(2) April-July	(3) (1)÷(2)	(4) June-July	(5) April-July
1978.....	387	3134	12%	-253	696
1979.....	1014	3336	30%	327	903
1980.....	835	2096	40%	37	-435
1981.....	1193	2267	53%	326	-369
1982.....	807	2632	31%	-150	-95
1983.....	1460	4433	33%	482	1619
1984.....	672	3856	17%	-353	993

Source: Current Population Survey

U.S. DEPARTMENT OF LABOR
Bureau of Labor Statistics
August 3, 1984

Unemployment rates of all civilian workers by alternative seasonal adjustment methods

Month and year	Unadjusted rate	X-11 ARIMA method						X-11 method (official method before 1980)	Range (cols. 2-8)
		Official procedure	Concurrent	Stable	Total	Residual	12-month extrapolation		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1983									
July.....	9.4	9.5	9.5	9.4	9.5	9.5	9.5	9.5	.1
August.....	9.2	9.5	9.5	9.4	9.5	9.5	9.5	9.5	.1
September....	8.8	9.2	9.2	9.2	9.2	9.1	9.2	9.3	.2
October.....	8.4	8.8	8.8	9.0	8.8	8.8	8.8	8.9	.2
November.....	8.1	8.4	8.4	8.5	8.4	8.4	8.4	8.4	.1
December.....	8.0	8.2	8.2	8.4	8.2	8.2	8.2	8.2	.2
1984									
January.....	8.8	8.0	8.0	8.0	8.1	8.0	8.0	8.0	.1
February.....	8.4	7.8	7.8	7.6	7.8	7.7	7.8	7.8	.2
March.....	8.1	7.8	7.8	7.7	7.8	7.6	7.8	7.7	.2
April.....	7.6	7.8	7.8	7.8	7.8	7.8	7.8	7.8	-
May.....	7.2	7.5	7.5	7.6	7.4	7.6	7.5	7.5	.2
June.....	7.4	7.1	7.2	7.1	7.2	7.3	7.1	7.2	.2
July.....	7.5	7.5	7.5	7.5	7.6	7.5	7.5	7.5	.1

SOURCE: U.S. DEPARTMENT OF LABOR
Bureau of Labor Statistics
August 1984

(1) Unadjusted rate. Unemployment rate for all civilian workers, not seasonally adjusted.

(2) Official procedure (X-11 ARIMA method). The published seasonally adjusted rate for all civilian workers. Each of the 3 major civilian labor force components--agricultural employment, nonagricultural employment and unemployment--for 4 age-sex groups--males and females, ages 16-19 and 20 years and over--are seasonally adjusted independently using data from January 1974 forward. The data series for each of these 12 components are extended by a year at each end of the original series using ARIMA (Auto-Regressive, Integrated, Moving Average) models chosen specifically for each series. Each extended series is then seasonally adjusted with the X-11 portion of the X-11 ARIMA program. The 4 teenage unemployment and nonagricultural employment components are adjusted with the additive adjustment model, while the other components are adjusted with the multiplicative model. The unemployment rate is computed by summing the 4 seasonally adjusted unemployment components and calculating that total as a percent of the civilian labor force total derived by summing all 12 seasonally adjusted components. All the seasonally adjusted series are revised at the end of each year. Extrapolated factors for January-June are computed at the beginning of each year; extrapolated factors for July-December are computed in the middle of the year after the June data become available. Each set of 6-month factors are published in advance, in the January and July issues, respectively, of Employment and Earnings.

(3) Concurrent (X-11 ARIMA method). The official procedure for computation of the rate for all civilian workers using the 12 components is followed except that extrapolated factors are not used at all. Each component is seasonally adjusted with the X-11 ARIMA program each month as the most recent data become available. Rates for each month of the current year are shown as first computed; they are revised only once each year, at the end of the year when data for the full year become available. For example, the rate for January 1984 would be based, during 1984, on the adjustment of data from the period January 1974 through January 1984.

(4) Stable (X-11 ARIMA method). Each of the 12 civilian labor force components is extended using ARIMA models as in the official procedure and then run through the X-11 part of the program using the stable option. This option assumes that seasonal patterns are basically constant from year-to-year and computes final seasonal factors as unweighted averages of all the seasonal-irregular components for each month across the entire span of the period adjusted. As in the official procedure, factors are extrapolated in 6-month intervals and the series are revised at the end of each year. The procedure for computation of the rate from the seasonally adjusted components is also identical to the official procedure.

(5) Total (X-11 ARIMA method). This is one alternative aggregation procedure, in which total unemployment and civilian labor force levels are extended with ARIMA models and directly adjusted with multiplicative adjustment models in the X-11 part of the program. The rate is computed by taking seasonally adjusted total unemployment as a percent of seasonally adjusted total civilian labor force. Factors are extrapolated in 6-month intervals and the series revised at the end of each year.

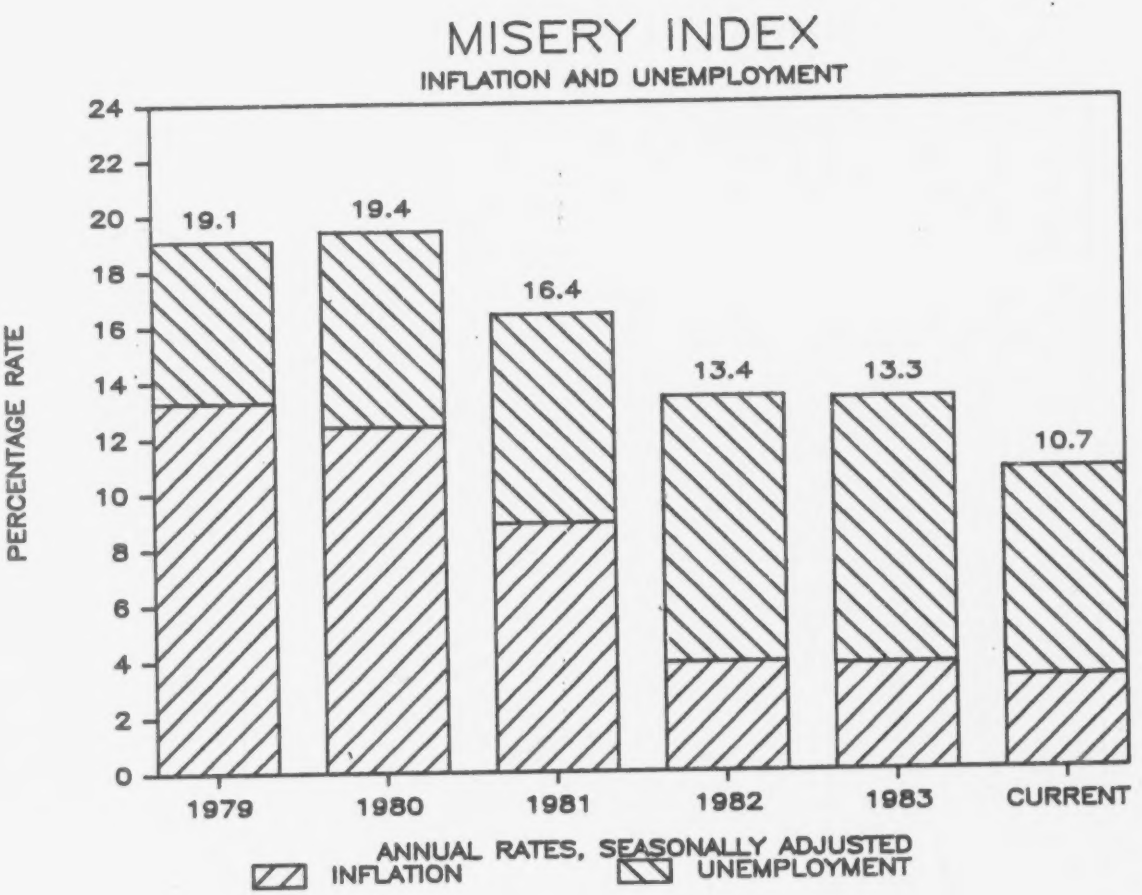
(6) Residual (X-11 ARIMA method). This is another alternative aggregation method, in which total civilian employment and civilian labor force levels are extended using ARIMA models and then directly adjusted with multiplicative adjustment models. The seasonally adjusted unemployment level is derived by subtracting seasonally adjusted employment from seasonally adjusted labor force. The rate is then computed by taking the derived unemployment level as a percent of the labor force level. Factors are extrapolated in 6-month intervals and the series revised at the end of each year.

(7) 12-month extrapolation (X-11 ARIMA method). This approach is the same as the official procedure except that the factors are extrapolated in 12-month intervals. The factors for January-December of the current year are computed at the beginning of the year based on data through the preceding year. The values for January through June of the current year are the same as the official values since they reflect the same factors.

(8) X-11 method (official method before 1980). The method for computation of the official procedure is used except that the series are not extended with ARIMA models and the factors are projected in 12-month intervals. The standard X-11 program is used to perform the seasonal adjustment.

Methods of Adjustment: The X-11 ARIMA method was developed at Statistics Canada by the Seasonal Adjustment and Times Series Staff under the direction of Estela Bee Dagum. The method is described in The X-11 ARIMA Seasonal Adjustment Method, by Estela Bee Dagum, Statistics Canada Catalogue No. 12-564E, February 1980.

The standard X-11 method is described in X-11 Variant of the Census Method II Seasonal Adjustment Program, by Julius Shiskin, Allan Young and John Musgrave (Technical Paper No. 15, Bureau of the Census, 1967).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AUGUST 3, 1984

THE EMPLOYMENT SITUATION: JULY 1984

Unemployment rose in July, returning to the May level, while the two major employment measures showed differing movements, the Bureau of Labor Statistics of the U.S. Department of Labor reported today. The overall jobless rate, which includes the resident Armed Forces in the labor force base, was 7.4 percent, and the rate for civilian workers was 7.5 percent. Each measure rose four-tenths of a percentage point over the month, after identical declines in June.

Total civilian employment--as measured by the monthly survey of households--fell by 350,000 in July after seasonal adjustment to 105.4 million. This first decline in the series in one and a half years, followed 2 months of exceptionally large increases. In contrast, the number of employees on nonagricultural payrolls--as measured by the monthly survey of establishments--rose by 300,000 over the month, continuing the steady growth that has occurred since early 1983. Despite these differing directions in July, the household series shows employment growth of 6.4 million over the course of the recovery, compared with job gains of 5.7 million in the payroll series.

Unemployment (Household Survey Data)

The number of unemployed persons increased to 8.5 million from June to July after seasonal adjustment, and the civilian worker unemployment rate rose to 7.5 percent; both figures returned to the levels posted in May. Since November 1982, the number of unemployed persons has declined by 3.3 million, and the jobless rate has dropped by 3.2 percentage points. (See table A-2.)

The July increase occurred primarily among adult women, whose jobless rate returned to the level that had essentially prevailed between February and May. The rate for adult men edged up to 6.5 percent, the same as in May, but was still below the rates posted earlier this year. Unemployment increased among both white and black workers. While the rate for white teenagers changed little, the rate for black youth, which is subject to wide fluctuation, rose by 8 percentage points in July to 42.4 percent; it had declined by a similar magnitude in June. (See tables A-2 and A-3.)

Most of the July increase took place among workers who had lost their jobs. There was little or no over-the-month change in either the number of persons who were on layoff (expecting to be recalled to their job), had left their job voluntarily, or were entering or reentering the labor force. The number of short-term (less than 5 weeks) and medium-term (5 to 14 weeks) jobless workers rose in July, while the number of long-term unemployed (15 weeks and over) was about unchanged. (See tables A-7 and A-8.)

Civilian Employment and the Labor Force (Household Survey Data)

Civilian employment fell by 355,000 over the month to 105.4 million, seasonally adjusted, after rising by 1.3 million in the prior 2 months. Civilian employment was 6.4 million above the November 1982 recession trough. (See table A-2.)

The civilian labor force was 113.9 million in July, unchanged from June. The proportion of the civilian working-age population in the labor force was 64.6 percent, the same as in the previous 2 months. Over the year, the labor force grew by 2.2 million, and the participation rate was up by about half a percentage point.

Centennial of Labor Statistics

Industry Payroll Employment (Establishment Survey Data)

Nonfarm payroll employment rose by 300,000 in July to 94.4 million, seasonally adjusted. The growth in employment was widespread, as two-thirds of the 185 industries in the BLS index of diffusion registered over-the-month gains. (See tables B-1 and B-6.)

Manufacturing employment continued its expansion in July with an increase of 105,000. Advances took place in both the durable and nondurable goods industries. Within durable goods, employment increased markedly in fabricated metal products, machinery, and electrical and electronic equipment. The employment rise in nondurable goods manufacturing--the first since April--reflected an increase in apparel and small gains in several other industries. Elsewhere in the goods-producing sector, employment in construction increased by 30,000, following an even larger gain in the previous month, and mining employment was unchanged.

In the service-producing sector, there were employment increases in transportation and public utilities, wholesale trade of durable goods, and the business and health services

Table A. Major indicators of labor market activity, seasonally adjusted

Category	Quarterly averages			Monthly data			June-July change
	1983	1984		1984			
	II	I	II	May	June	July	
HOUSEHOLD DATA							
	Thousands of persons						
Labor force 1/	112,946	114,292	115,333	115,493	115,567	115,636	69
Total employment 1/	101,706	105,426	106,837	106,978	107,438	107,093	-345
Civilian labor force	111,277	112,607	113,642	113,803	113,877	113,938	61
Civilian employment	100,037	103,740	105,146	105,288	105,748	105,395	-353
Unemployment	11,240	8,866	8,496	8,514	8,130	8,543	413
Not in labor force	62,680	63,072	62,484	62,320	62,407	62,503	96
Discouraged workers	1,726	1,339	1,295	N.A.	N.A.	N.A.	N.A.
	Percent of labor force						
Unemployment rates:							
All workers 1/	10.0	7.8	7.4	7.4	7.0	7.4	0.4
All civilian workers	10.1	7.9	7.5	7.5	7.1	7.5	0.4
Adult men	9.4	7.0	6.6	6.5	6.3	6.5	0.2
Adult women	8.5	7.0	6.7	6.8	6.4	6.9	0.5
Teenagers	23.3	19.6	18.7	19.0	17.6	18.3	0.7
White	8.8	6.8	6.4	6.4	6.1	6.4	0.3
Black	20.4	16.5	15.9	15.8	15.0	16.9	1.9
Hispanic origin	14.2	10.9	10.7	10.5	10.0	10.6	0.6
ESTABLISHMENT DATA							
	Thousands of jobs						
Nonfarm payroll employment	89,588	92,765	93,764p	93,768	94,076p	94,378p	302p
Goods-producing industries	23,092	24,518	24,867p	24,851	24,989p	25,126p	137p
Service-producing industries	66,496	68,247	68,898p	68,917	69,087p	69,252p	165p
	Hours of work						
Average weekly hours:							
Total private nonfarm	34.9	35.3	35.3p	35.3	35.3p	35.3p	0p
Manufacturing	40.0	40.8	40.7p	40.6	40.5p	40.6p	0.1p
Manufacturing overtime	2.8	3.5	3.4p	3.3	3.3p	3.4p	0.1p

1/ Includes the resident Armed Forces.
N.A.=not available.
p=preliminary.

industries. The increase in health services reflects, in part, the settlement of a nurses' strike.

Weekly Hours (Establishment Survey Data)

The average workweek of production or nonsupervisory workers on private nonagricultural payrolls in July--35.3 hours, seasonally adjusted--was unchanged for the third month in a row. Similarly, average weekly and overtime hours in manufacturing, at 40.6 and 3.4 hours, respectively, were both about the same as in the prior 2 months. (See table B-2.)

The index of aggregate weekly hours of production or nonsupervisory workers on private nonfarm payrolls rose by 0.3 percent in July to 112.9 (1977=100), reflecting the rise in employment. The manufacturing index increased 0.8 percent to 96.8. (See table B-5.)

Hourly and Weekly Earnings (Establishment Survey Data)

Average hourly and weekly earnings both increased 0.5 percent in July, seasonally adjusted. Prior to seasonal adjustment, average hourly earnings rose 4 cents to $8.34, and weekly earnings increased $3.09 to $297.74. Over the past year, hourly earnings have risen 33 cents and weekly earnings $14.99. (See table B-3.)

The Hourly Earnings Index (Establishment Survey Data)

The Hourly Earnings Index (HEI) was 161.1 (1977=100) in July, seasonally adjusted, an increase of 0.5 percent from June. For the 12 months ended in July, the increase (before seasonal adjustment) was 3.5 percent. The HEI excludes the effects of two types of changes unrelated to underlying wage rate movements--fluctuations in overtime in manufacturing, and interindustry employment shifts. In dollars of constant purchasing power, the HEI increased 0.3 percent during the 12-month period ended in June. (See table B-4.)

Explanatory Note

This news release presents statistics from two major surveys, the Current Population Survey (household survey) and the Current Employment Statistics Survey (establishment survey). The household survey provides the information on the labor force, total employment, and unemployment that appears in the A tables, marked HOUSEHOLD DATA. It is a sample survey of about 60,000 households that is conducted by the Bureau of the Census with most of the findings analyzed and published by the Bureau of Labor Statistics (BLS).

The establishment survey provides the information on the employment, hours, and earnings of workers on nonagricultural payrolls that appears in the B tables, marked ESTABLISHMENT DATA. This information is collected from payroll records by BLS in cooperation with State agencies. The sample includes approximately 195,000 establishments employing over 35 million people.

For both surveys, the data for a given month are actually collected for and relate to a particular week. In the household survey, unless otherwise indicated, it is the calendar week that contains the 12th day of the month, which is called the survey week. In the establishment survey, the reference week is the pay period including the 12th, which may or may not correspond directly to the calendar week.

The data in this release are affected by a number of technical factors, including definitions, survey differences, seasonal adjustments, and the inevitable variance in results between a survey of a sample and a census of the entire population. Each of these factors is explained below.

Coverage, definitions, and differences between surveys

The sample households in the household survey are selected so as to reflect the entire civilian noninstitutional population 16 years of age and older. Each person in a household is classified as employed, unemployed, or not in the labor force. Those who hold more than one job are classified according to the job at which they worked the most hours.

People are classified as *employed* if they did any work at all as paid civilians; worked in their own business or profession or on their own farm; or worked 15 hours or more in an enterprise operated by a member of their family, whether they were paid or not. People are also counted as employed if they were on unpaid leave because of illness, bad weather, disputes between labor and management, or personal reasons. Members of the Armed Forces stationed in the United States are also included in the employed total.

People are classified as *unemployed*, regardless of their eligibility for unemployment benefits or public assistance, if they meet all of the following criteria: They had no employment during the survey week; they were available for work at that time; and they made specific efforts to find employment sometime during the prior 4 weeks. Also included among the unemployed are persons not looking for work because they were laid off and waiting to be recalled and those expecting to report to a job within 30 days.

The *labor force* equals the sum of the number employed and the number unemployed. The *unemployment rate* is the percentage of unemployed people in the labor force (civilian plus the resident Armed Forces). Table A-5 presents a special grouping of seven measures of unemployment based on varying definitions of unemployment and the labor force. The definitions are provided in the table. The most restrictive definition yields U-1 and the most comprehensive yields U-7. The overall unemployment rate is U-5a, while U-5b represents the same measure with a civilian labor force base.

Unlike the household survey, the establishment survey only counts wage and salary employees whose names appear on the payroll records of nonagricultural firms. As a result, there are many differences between the two surveys, among which are the following:

- The household survey, although based on a smaller sample, reflects a larger segment of the population; the establishment survey excludes agriculture, the self-employed, unpaid family workers, private household workers, and members of the resident Armed Forces;

- The household survey includes people on unpaid leave among the employed; the establishment survey does not;

- The household survey is limited to those 16 years of age and older; the establishment survey is not limited by age;

- The household survey has no duplication of individuals, because each individual is counted only once; in the establishment survey, employees working at more than one job or otherwise appearing on more than one payroll would be counted separately for each appearance.

Other differences between the two surveys are described in "Comparing Employment Estimates from Household and Payroll Surveys," which may be obtained from the BLS upon request.

Seasonal adjustment

Over the course of a year, the size of the Nation's labor force and the levels of employment and unemployment undergo sharp fluctuations due to such seasonal events as changes in weather, reduced or expanded production, harvests, major holidays, and the opening and closing of schools. For example, the labor force increases by a large number each June, when schools close and many young people enter the job market. The effect of such seasonal variation can be very large; over the course of a year, for example, seasonality may account for as much as 95 percent of the month-to-month changes in unemployment.

Because these seasonal events follow a more or less regular pattern each year, their influence on statistical trends can be eliminated by adjusting the statistics from month to month. These adjustments make nonseasonal developments, such as declines in economic activity or increases in the participation of women in the labor force, easier to spot. To return to the school's-out example, the large number of people entering the labor force each June is likely to obscure any other changes that have taken place since May, making it difficult to determine if the level of economic activity has risen or declined. However, because the effect of students finishing school in previous years is known, the statistics for the current year can be adjusted to allow for a comparable change. Insofar as the seasonal adjustment is made correctly, the adjusted figure provides a more useful tool with which to analyze changes in economic activity.

Measures of labor force, employment, and unemployment contain components such as age and sex. Statistics for all employees, production workers, average weekly hours, and average hourly earnings include components based on the employer's industry. All these statistics can be seasonally adjusted either by adjusting the total or by adjusting each of the components and combining them. The second procedure usually yields more accurate information and is therefore followed by BLS. For example, the seasonally adjusted figure for the labor force is the sum of eight seasonally adjusted civilian employment components, plus the resident Armed Forces total (not adjusted for seasonality), and four seasonally adjusted unemployment components; the total for unemployment is the sum of the four unemployment components; and the overall unemployment rate is derived by dividing the resulting estimate of total unemployment by the estimate of the labor force.

The numerical factors used to make the seasonal adjustments are recalculated regularly. For the household survey, the factors are calculated for the January-June period and again for the July-December period. The January revision is applied to data that have been published over the previous 5 years. For the establishment survey, updated factors for seasonal adjustment are calculated only once a year, along with the introduction of new benchmarks which are discussed at the end of the next section.

Sampling variability

Statistics based on the household and establishment surveys are subject to sampling error, that is, the estimate of the number of people employed and the other estimates drawn from these surveys probably differ from the figures that would be obtained from a complete census, even if the same questionnaires and procedures were used. In the household survey, the amount of the differences can be expressed in terms of standard errors. The numerical value of a standard error depends upon the size of the sample, the results of the survey, and other factors. However, the numerical value is always such that the chances are approximately 68 out of 100 that an estimate based on the sample will differ by no more than the standard error from the results of a complete census. The chances are approximately 90 out of 100 that an estimate based on the sample will differ by no more than 1.6 times the standard error from the results of a complete census. At approximately the 90-percent level of confidence—the confidence limits used by BLS in its analyses—the error for the monthly change in total employment is on the order of plus or minus 328,000; for total unemployment it is 220,000; and, for the overall unemployment rate, it is 0.19 percentage point. These figures do not mean that the sample results are off by these magnitudes but, rather, that the chances are approximately 90 out of 100 that the "true" level or rate would not be expected to differ from the estimates by more than these amounts.

Sampling errors for monthly surveys are reduced when the data are cumulated for several months, such as quarterly or annually. Also, as a general rule, the smaller the estimate, the larger the sampling error. Therefore, relatively speaking, the estimate of the size of the labor force is subject to less error than is the estimate of the number unemployed. And, among the unemployed, the sampling error for the jobless rate of adult men, for example, is much smaller than is the error for the jobless rate of teenagers. Specifically, the error on monthly change in the jobless rate for men is .26 percentage point; for teenagers, it is 1.25 percentage points.

In the establishment survey, estimates for the 2 most current months are based on incomplete returns; for this reason, these estimates are labeled preliminary in the tables. When all the returns in the sample have been received, the estimates are revised. In other words, data for the month of September are published in preliminary form in October and November and in final form in December. To remove errors that build up over time, a comprehensive count of the employed is conducted each year. The results of this survey are used to establish new benchmarks—comprehensive counts of employment—against which month-to-month changes can be measured. The new benchmarks also incorporate changes in the classification of industries and allow for the formation of new establishments.

Additional statistics and other information

In order to provide a broad view of the Nation's employment situation, BLS regularly publishes a wide variety of data in this news release. More comprehensive statistics are contained in *Employment and Earnings*, published each month by BLS. It is available for $6.00 per issue or $39.00 per year from the U.S. Government Printing Office, Washington, D.C., 20204. A check or money order made out to the Superintendent of Documents must accompany all orders.

Employment and Earnings also provides approximations of the standard errors for the household survey data published in this release. For unemployment and other labor force categories, the standard errors appear in tables B through J of its "Explanatory Notes." Measures of the reliability of the data drawn from the establishment survey and the actual amounts of revision due to benchmark adjustments are provided in tables M, O, P, and Q of that publication.

Table A-1. Employment status of the population, including Armed Forces in the United States, by sex

(Numbers in thousands)

Employment status and sex	Not seasonally adjusted			Seasonally adjusted[1]					
	July 1983	June 1984	July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984	July 1984
TOTAL									
Noninstitutional population[2]	175,970	177,974	178,138	175,970	177,510	177,662	177,813	177,974	178,138
Labor force[3]	115,644	117,083	117,896	113,489	114,598	114,938	115,493	115,567	115,636
Participation rate[4]	65.7	65.8	66.2	64.5	64.6	64.7	65.0	64.9	64.9
Total employed[5]	104,937	108,502	109,182	102,889	105,826	106,095	106,978	107,438	107,093
Employment-population ratio[6]	59.6	61.0	61.3	58.5	59.6	59.7	60.2	60.4	60.1
Resident Armed Forces	1,664	1,690	1,698	1,664	1,686	1,693	1,690	1,690	1,698
Civilian employed	103,273	106,812	107,484	101,225	104,140	104,402	105,288	105,748	105,395
Agriculture	3,129	3,879	3,948	3,499	3,281	3,293	3,389	3,403	3,345
Nonagricultural industries	99,144	102,932	103,536	97,726	100,859	101,009	101,899	102,344	102,050
Unemployed	10,707	8,582	8,714	10,600	8,772	8,843	8,514	8,130	8,543
Unemployment rate[7]	9.3	7.3	7.4	9.3	7.7	7.7	7.4	7.0	7.4
Not in labor force	60,326	60,891	60,242	62,481	62,912	62,724	62,320	62,407	62,503
Men, 16 years and over									
Noninstitutional population[2]	84,095	85,101	85,179	84,099	84,880	84,953	85,026	85,101	85,179
Labor force[3]	66,586	66,802	67,206	64,840	65,156	65,212	65,307	65,452	65,362
Participation rate[4]	79.2	78.5	78.9	77.1	76.8	76.8	76.8	76.9	76.7
Total employed[5]	60,471	62,138	62,533	58,592	60,290	60,293	60,629	60,923	60,607
Employment-population ratio[6]	71.9	73.0	73.4	69.7	71.0	71.0	71.3	71.6	71.2
Resident Armed Forces	1,521	1,545	1,551	1,521	1,542	1,548	1,545	1,545	1,551
Civilian employed	58,950	60,593	60,982	57,071	58,748	58,745	59,084	59,378	59,056
Unemployed	6,097	4,664	4,674	6,248	4,867	4,919	4,678	4,529	4,756
Unemployment rate[7]	9.2	7.0	7.0	9.6	7.5	7.5	7.2	6.9	7.3
Women, 16 years and over									
Noninstitutional population[2]	91,871	92,873	92,958	91,871	92,630	92,709	92,769	92,873	92,958
Labor force[3]	49,076	50,281	50,689	48,649	49,442	49,725	50,186	50,115	50,273
Participation rate[4]	53.4	54.1	54.5	53.0	53.4	53.6	54.1	54.0	54.1
Total employed[5]	44,466	46,364	46,649	44,297	45,536	45,802	46,350	46,515	46,486
Employment-population ratio[6]	48.4	49.9	50.2	48.2	49.2	49.4	50.0	50.1	50.0
Resident Armed Forces	143	145	147	143	144	145	145	145	147
Civilian employed	44,323	46,219	46,502	44,154	45,392	45,657	46,205	46,370	46,339
Unemployed	4,610	3,917	4,040	4,352	3,905	3,924	3,836	3,600	3,787
Unemployment rate[7]	9.4	7.8	8.0	8.9	7.9	7.9	7.6	7.2	7.5

[1] The population and Armed Forces figures are not adjusted for seasonal variation; therefore, identical numbers appear in the unadjusted and seasonally adjusted columns.

[2] Includes members of the Armed Forces stationed in the United States.

[3] Labor force as a percent of the noninstitutional population.

[4] Total employment as a percent of the noninstitutional population.

[5] Unemployment as a percent of the labor force (including the resident Armed Forces).

HOUSEHOLD DATA

Table A-2. Employment status of the civilian population by sex and age

(Numbers in thousands)

Employment status, sex, and age	Not seasonally adjusted			Seasonally adjusted[1]					
	July 1983	June 1984	July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984	July 1984
TOTAL									
Civilian noninstitutional population	174,306	176,284	176,440	174,306	175,824	175,969	176,123	176,284	176,440
Civilian labor force	113,980	115,393	116,198	111,925	112,912	113,245	113,803	113,677	113,938
Participation rate	65.4	65.5	65.9	64.2	64.2	64.4	64.6	64.6	64.6
Employed	103,273	106,812	107,484	101,225	104,140	104,402	105,288	105,748	105,395
Employment-population ratio[2]	59.2	60.6	60.9	58.1	59.2	59.3	59.8	60.0	59.7
Unemployed	10,707	8,582	8,714	10,600	8,772	8,843	8,514	8,130	8,543
Unemployment rate	9.4	7.4	7.5	9.5	7.8	7.8	7.5	7.1	7.5
Men, 20 years and over									
Civilian noninstitutional population	74,927	76,176	76,269	74,927	75,880	75,973	76,073	76,176	76,269
Civilian labor force	59,492	60,224	60,341	58,742	59,388	59,480	59,546	59,726	59,694
Participation rate	79.4	79.1	79.1	78.7	78.3	78.3	78.3	78.4	78.3
Employed	54,570	56,585	56,662	53,765	55,368	55,385	55,685	55,970	55,789
Employment-population ratio[2]	72.8	74.3	74.3	71.8	73.0	72.9	73.2	73.5	73.1
Agriculture	2,742	2,657	2,688	2,521	2,364	2,453	2,451	2,469	2,455
Nonagricultural industries	51,828	53,928	53,974	51,244	53,004	52,932	53,234	53,501	53,334
Unemployed	4,922	3,639	3,679	5,217	4,020	4,095	3,861	3,755	3,906
Unemployment rate	8.3	6.0	6.1	8.8	6.8	6.9	6.5	6.3	6.5
Women, 20 years and over									
Civilian noninstitutional population	84,122	85,380	85,488	84,122	85,064	85,168	85,272	85,380	85,488
Civilian labor force	44,150	45,649	45,746	44,647	45,459	45,703	46,222	46,101	46,261
Participation rate	52.5	53.5	53.5	53.1	53.4	53.7	54.2	54.0	54.1
Employed	40,544	42,678	42,499	41,123	42,315	42,517	43,098	43,146	43,080
Employment-population ratio[2]	48.2	50.0	49.7	48.9	49.7	49.9	50.5	50.5	50.4
Agriculture	758	750	707	613	574	619	610	623	573
Nonagricultural industries	39,786	41,928	41,792	40,510	41,741	41,898	42,487	42,523	42,515
Unemployed	3,606	2,970	3,246	3,524	3,144	3,186	3,124	2,955	3,173
Unemployment rate	8.2	6.5	7.1	7.9	6.9	7.0	6.8	6.4	6.9
Both sexes, 16 to 19 years									
Civilian noninstitutional population	15,257	14,728	14,683	15,257	14,880	14,828	14,778	14,728	14,683
Civilian labor force	10,338	9,520	10,111	8,196	8,065	8,062	8,034	8,050	7,982
Participation rate	67.8	64.6	68.9	53.7	54.2	54.4	54.4	54.7	54.4
Employed	8,159	7,548	8,323	6,337	6,457	6,500	6,505	6,631	6,518
Employment-population ratio[2]	53.5	51.2	56.7	41.5	43.4	43.8	44.0	45.0	44.4
Agriculture	629	473	553	365	343	321	327	311	317
Nonagricultural industries	7,530	7,075	7,770	5,972	6,114	6,179	6,178	6,320	6,201
Unemployed	2,179	1,972	1,788	1,859	1,608	1,562	1,529	1,419	1,466
Unemployment rate	21.1	20.7	17.7	22.7	19.9	19.4	19.0	17.6	18.3

[1] The population figures are not adjusted for seasonal variation; therefore, identical numbers appear in the unadjusted and seasonally adjusted columns.

[2] Civilian employment as a percent of the civilian noninstitutional population.

HOUSEHOLD DATA

Table A-3. Employment status of the civilian population by race, sex, age, and Hispanic origin

(Numbers in thousands)

Employment status, race, sex, age, and Hispanic origin	Not seasonally adjusted			Seasonally adjusted[1]					
	July 1983	June 1984	July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984	July 1984
WHITE									
Civilian noninstitutional population	150,959	152,295	152,486	150,959	152,295	152,178	152,229	152,295	152,286
Civilian labor force	98,911	100,090	100,488	97,255	98,426	98,485	98,853	98,770	98,710
Participation rate	65.5	65.7	66.0	64.4	64.6	64.7	64.9	64.9	64.8
Employed	91,012	93,772	94,257	89,260	91,845	91,933	92,505	92,697	92,430
Employment-population ratio[2]	60.3	61.6	61.9	59.1	60.3	60.4	60.8	60.9	60.7
Unemployed	7,899	6,319	6,231	7,995	6,580	6,562	6,348	6,072	6,280
Unemployment rate	8.0	6.3	6.2	8.2	6.7	6.7	6.4	6.1	6.4
Men, 20 years and over									
Civilian labor force	52,367	52,990	52,967	51,901	52,398	52,406	52,357	52,348	52,366
Participation rate	79.7	79.5	79.5	79.0	78.8	78.8	78.7	78.9	78.6
Employed	48,654	50,291	50,311	47,891	49,343	49,329	49,440	49,744	49,470
Employment-population ratio[2]	74.1	75.5	75.5	72.9	74.2	74.2	74.3	74.7	74.3
Unemployed	3,713	2,700	2,656	4,010	3,055	3,077	2,917	2,604	2,896
Unemployment rate	7.1	5.1	5.0	7.7	5.8	5.9	5.6	5.3	5.5
Women, 20 years and over									
Civilian labor force	37,646	38,847	38,865	38,161	38,873	39,032	39,439	39,226	39,206
Participation rate	51.8	52.8	52.8	52.5	52.9	53.1	53.7	53.3	53.5
Employed	35,026	36,672	36,518	35,574	36,570	36,688	37,150	37,042	37,074
Employment-population ratio[2]	48.2	49.9	49.6	48.9	49.8	49.9	50.5	50.4	50.4
Unemployed	2,620	2,175	2,347	2,587	2,303	2,344	2,289	2,184	2,321
Unemployment rate	7.0	5.6	6.0	6.8	5.9	6.0	5.8	5.6	5.9
Both sexes, 16 to 19 years									
Civilian labor force	8,898	8,253	8,655	7,193	7,153	7,057	7,057	6,996	6,948
Participation rate	70.7	68.0	71.6	57.2	58.7	57.7	58.0	57.7	57.5
Employed	7,332	6,809	7,428	5,795	5,932	5,916	5,915	5,911	5,886
Employment-population ratio[2]	58.3	56.1	61.4	46.1	48.3	48.4	48.6	48.7	48.7
Unemployed	1,566	1,444	1,228	1,398	1,221	1,141	1,142	1,085	1,062
Unemployment rate	17.6	17.5	14.2	19.4	17.1	16.2	16.2	15.5	15.3
Unemployment rate	17.5	17.1	15.4	20.3	17.3	16.4	16.8	16.5	17.8
Men	17.7	17.9	12.9	18.4	16.8	15.7	15.5	14.5	12.6
Women									
BLACK									
Civilian noninstitutional population	18,942	19,330	19,360	18,942	19,248	19,274	19,302	19,330	19,360
Civilian labor force	12,186	12,230	12,536	11,741	11,867	11,934	12,008	11,962	12,076
Participation rate	64.3	63.3	64.8	62.0	61.7	61.9	62.2	61.9	62.4
Employed	9,717	10,222	10,334	9,443	9,896	9,923	10,105	10,168	10,041
Employment-population ratio[2]	51.3	52.9	53.4	49.9	51.4	51.5	52.4	52.6	51.9
Unemployed	2,469	2,009	2,202	2,298	1,972	2,011	1,903	1,795	2,035
Unemployment rate	20.3	16.4	17.6	19.6	16.6	16.8	15.8	15.0	16.9
Men, 20 years and over									
Civilian labor force	5,661	5,703	5,769	5,599	5,660	5,687	5,673	5,696	5,700
Participation rate	76.8	75.1	75.8	76.0	75.0	74.2	74.9	74.9	74.9
Employed	4,614	4,864	4,860	4,559	4,789	4,712	4,872	4,811	4,802
Employment-population ratio[2]	62.6	64.1	63.9	61.9	63.5	62.4	64.3	63.4	63.1
Unemployed	1,046	839	909	1,040	871	894	801	885	897
Unemployment rate	18.5	14.7	15.8	18.6	15.4	16.0	14.1	14.8	15.7
Women, 20 years and over									
Civilian labor force	5,331	5,485	5,539	5,317	5,425	5,469	5,547	5,496	5,522
Participation rate	57.0	57.3	57.7	56.9	57.0	57.3	58.0	57.4	57.5
Employed	4,450	4,779	4,751	4,458	4,690	4,737	4,793	4,818	4,746
Employment-population ratio[2]	47.6	49.9	49.5	47.7	49.2	49.6	50.1	50.3	49.5
Unemployed	881	706	788	859	735	731	754	679	776
Unemployment rate	16.5	12.9	14.2	16.2	13.5	13.4	13.6	12.4	14.0
Both sexes, 16 to 19 years									
Civilian labor force	1,194	1,042	1,228	825	783	859	787	820	854
Participation rate	53.7	48.2	57.0	37.1	35.9	39.5	36.3	37.9	39.6
Employed	653	579	723	426	417	474	440	539	492
Employment-population ratio[2]	29.3	26.8	33.5	19.1	19.1	21.8	20.3	24.9	22.8
Unemployed	542	464	505	399	366	385	347	281	362
Unemployment rate	45.3	44.5	41.1	48.4	46.7	44.8	44.1	34.3	42.4
Men	44.6	43.2	40.3	48.3	48.4	42.8	40.9	35.3	42.6
Women	46.3	46.0	42.0	48.4	49.6	47.1	48.2	33.1	42.1
HISPANIC ORIGIN									
Civilian noninstitutional population	9,640	9,824	9,738	9,640	10,080	10,072	10,026	9,824	9,738
Civilian labor force	6,206	6,410	6,432	6,090	6,484	6,379	6,332	6,298	6,293
Participation rate	64.8	65.2	66.1	63.2	64.3	63.3	63.2	64.1	64.6
Employed	5,448	5,760	5,733	5,339	5,751	5,643	5,666	5,469	5,426
Employment-population ratio[2]	56.5	58.6	58.9	55.4	57.1	56.0	56.5	57.7	557.8
Unemployed	798	651	700	751	733	735	666	829	867
Unemployment rate	12.8	10.2	10.9	12.3	11.3	11.5	10.5	10.0	10.6

[1] The population figures are not adjusted for seasonal variation; therefore, identical numbers appear in the unadjusted and seasonally adjusted columns.

[2] Civilian employment as a percent of the civilian noninstitutional population.

NOTE: Detail for the above race and Hispanic-origin groups will not sum to totals because data for the "other races" group are not presented and Hispanics are included in both the white and black population groups.

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Table A-4. Selected employment indicators

(Numbers in thousands)

Category	Not seasonally adjusted			Seasonally adjusted					
	July 1983	June 1984	July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984	July 1984
CHARACTERISTIC									
Civilian employed, 16 years and over	103,273	106,812	107,688	101,225	106,160	106,402	105,288	105,748	105,395
Married men, spouse present	38,484	39,306	39,395	38,254	38,927	39,062	39,159	39,072	39,121
Married women, spouse present	23,925	25,270	25,022	24,618	25,239	25,457	25,722	25,786	25,716
Women who maintain families	5,012	5,642	5,628	5,071	5,444	5,491	5,668	5,688	5,662
MAJOR INDUSTRY AND CLASS OF WORKER									
Agriculture:									
Wage and salary workers	2,062	1,806	1,924	1,637	1,515	1,661	1,610	1,608	1,513
Self-employed workers	1,719	1,699	1,704	1,573	1,580	1,536	1,537	1,570	1,559
Unpaid family workers	348	295	320	251	198	207	248	242	238
Nonagricultural industries:									
Wage and salary workers	91,100	94,718	95,389	89,687	92,819	92,931	93,928	94,040	93,841
Government	15,100	15,309	15,105	15,593	15,813	15,784	15,761	15,685	15,604
Private industries	76,000	79,408	80,284	74,094	77,006	77,147	78,167	78,355	78,236
Private households	1,406	1,413	1,367	1,276	1,155	1,296	1,367	1,329	1,239
Other industries	74,596	77,995	78,917	72,818	75,851	75,851	76,820	77,026	76,997
Self-employed workers	7,689	7,851	7,810	7,595	7,755	7,834	7,707	7,828	7,717
Unpaid family workers	355	364	337	322	326	338	311	348	306
PERSONS AT WORK[1]									
Nonagricultural industries	87,767	95,860	92,251	92,126	94,982	96,918	96,523	96,500	96,868
Full-time schedules	71,192	78,731	75,906	73,844	77,004	78,276	78,280	78,496	78,659
Part time for economic reasons	6,686	6,117	6,201	5,700	5,463	5,593	5,353	5,491	5,300
Usually work full time	1,773	1,743	1,581	1,721	1,472	1,530	1,549	1,658	1,589
Usually work part time	4,913	4,374	4,620	3,919	3,991	4,063	3,804	3,837	3,711
Part time for noneconomic reasons	9,889	11,012	10,144	12,582	12,515	13,049	12,889	12,514	12,889

[1] Excludes persons "with a job but not at work" during the survey period for such reasons as vacation, illness, or industrial dispute.

Table A-5. Range of unemployment measures based on varying definitions of unemployment and the labor force, seasonally adjusted

(Percent)

Measure	Quarterly averages					Monthly data		
	1983			1984		1984		
	II	III	IV	I	II	May	June	July
U-1 Persons unemployed 15 weeks or longer as a percent of the civilian labor force	4.0	3.7	3.1	2.7	2.4	2.5	2.3	2.4
U-2 Job losers as a percent of the civilian labor force	6.0	5.6	4.7	4.2	3.8	3.8	3.7	4.0
U-3 Unemployed persons 25 years and over as a percent of the civilian labor force	7.9	7.3	6.6	6.1	5.8	5.7	5.6	5.9
U-4 Unemployed full-time jobseekers as a percent of the full-time civilian labor force	10.0	9.3	8.3	7.6	7.2	7.2	6.7	7.2
U-5a Total unemployed as a percent of the labor force, including the resident Armed Forces	10.0	9.3	8.4	7.8	7.4	7.4	7.0	7.4
U-5b Total unemployed as a percent of the civilian labor force	10.1	9.4	8.5	7.9	7.5	7.5	7.1	7.5
U-6 Total full-time jobseekers plus ½ part-time jobseekers plus ½ total on part time for economic reasons as a percent of the civilian labor force less ½ of the part-time labor force	12.9	12.2	11.2	10.5	9.9	9.9	9.5	9.9
U-7 Total full-time jobseekers plus ½ part-time jobseekers plus ½ total on part time for economic reasons plus discouraged workers as a percent of the civilian labor force plus discouraged workers less ½ of the part-time labor force	14.4	13.5	12.4	11.6	11.0	N.A.	N.A.	N.A.

N.A. = not available.

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Table A-6. Selected unemployment indicators, seasonally adjusted

Category	Number of unemployed persons (in thousands)			Unemployment rates*					
	July 1983	June 1984	July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984	July 1984
CHARACTERISTIC									
Total, 16 years and over	10,600	8,130	8,543	9.5	7.8	7.8	7.5	7.1	7.5
Men, 16 years and over	6,248	4,529	4,756	9.9	7.7	7.7	7.3	7.1	7.4
Men, 20 years and over	5,217	3,755	3,906	8.8	6.8	6.9	6.5	6.3	6.5
Women, 16 years and over	4,352	3,600	3,787	9.0	7.9	7.9	7.7	7.2	7.6
Women, 20 years and over	3,524	2,955	3,173	7.9	6.9	7.0	6.8	6.4	6.9
Both sexes, 16 to 19 years	1,859	1,419	1,864	22.7	19.9	19.4	19.0	17.6	18.3
Married men, spouse present	2,540	1,856	1,867	6.2	4.7	4.7	4.5	4.5	4.6
Married women, spouse present	1,854	1,516	1,615	7.0	5.8	5.8	5.6	5.6	5.9
Women who maintain families	676	602	602	11.8	11.0	10.5	9.8	9.4	9.6
Full-time workers	8,985	6,524	7,061	9.8	7.5	7.6	7.2	6.7	7.2
Part-time workers	1,648	1,649	1,550	10.2	9.2	9.1	9.3	10.3	9.8
Labor force time lost**	--	--	--	10.7	8.8	8.9	8.5	8.3	8.7
INDUSTRY									
Nonagricultural private wage and salary workers	7,921	5,865	6,289	9.7	7.6	7.7	7.2	7.0	7.4
Mining	180	75	77	16.6	11.2	10.3	14.8	14.8	14.7
Construction	985	820	839	18.0	13.3	14.3	7.1	7.2	7.5
Manufacturing	2,320	1,588	1,650	10.7	7.5	7.7	7.0	7.2	6.7
Durable goods	1,450	949	883	11.4	7.8	7.5	7.0	7.2	6.7
Nondurable goods	870	639	767	9.7	7.2	8.0	7.1	7.3	8.6
Transportation and public utilities	411	312	361	7.3	5.0	5.4	5.5	5.2	6.1
Wholesale and retail trade	2,051	1,562	1,693	9.8	8.3	8.7	7.9	7.2	7.8
Finance and service industries	1,974	1,508	1,669	7.3	6.4	6.1	5.5	5.4	5.9
Government workers	889	663	732	5.4	4.4	4.4	4.7	4.1	4.5
Agricultural wage and salary workers	247	214	259	15.0	14.6	12.2	13.9	11.8	14.6

* Unemployment as a percent of the civilian labor force.

** Aggregate hours lost by the unemployed and persons on part time for economic reasons as a percent of potentially available labor force hours.

Table A-7. Duration of unemployment

(Numbers in thousands)

Weeks of unemployment	Not seasonally adjusted			Seasonally adjusted					
	July 1983	June 1984	July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984	July 1984
DURATION									
Less than 5 weeks	3,786	4,005	3,642	3,529	3,386	3,438	3,238	3,174	3,462
5 to 14 weeks	3,046	1,973	2,649	2,841	2,539	2,493	2,433	2,294	2,490
15 weeks and over	3,253	2,603	2,423	4,398	2,873	2,855	2,851	2,619	2,689
15 to 26 weeks	1,618	1,018	815	1,794	1,114	1,111	1,166	1,008	1,100
27 weeks and over	2,636	1,585	1,608	2,604	1,759	1,744	1,664	1,611	1,589
Average (mean) duration, in weeks	20.0	17.3	17.0	21.3	18.8	18.5	18.4	18.6	18.1
Median duration, in weeks	8.8	5.9	6.5	10.1	8.3	8.1	8.7	7.2	7.6
PERCENT DISTRIBUTION									
Total unemployed	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Less than 5 weeks	34.6	46.7	41.8	32.8	38.5	39.1	38.0	39.2	40.1
5 to 14 weeks	28.4	23.0	30.4	26.4	28.9	28.4	28.6	28.4	28.8
15 weeks and over	36.9	30.3	27.8	40.8	32.7	32.5	33.5	32.4	31.1
15 to 26 weeks	14.3	11.9	9.4	16.7	12.7	12.6	13.9	12.5	12.7
27 weeks and over	24.6	18.5	18.5	24.2	20.0	19.8	19.5	19.9	18.4

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Table A-8. Reason for unemployment

(Numbers in thousands)

Reason	Not seasonally adjusted			Seasonally adjusted					
	July 1983	June 1984	July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984	July 1984
NUMBER OF UNEMPLOYED									
Job losers	5,990	3,563	4,258	6,235	4,614	4,527	4,327	4,220	4,511
On layoff	1,609	1,026	1,091	1,735	1,254	1,198	1,192	1,166	1,164
Other job losers	4,281	2,537	3,167	4,500	3,360	3,419	3,134	3,055	3,346
Job leavers	767	788	880	752	756	781	804	800	865
Reentrants	2,492	2,259	2,154	2,415	2,208	2,308	2,178	1,968	2,091
New entrants	1,559	1,614	1,621	1,229	1,213	1,216	1,186	1,136	1,092
PERCENT DISTRIBUTION									
Total unemployed	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Job losers	55.0	46.2	48.8	58.6	52.5	51.3	50.9	51.9	52.7
On layoff	15.0	12.0	12.5	16.3	14.3	12.5	14.0	14.4	13.6
Other job losers	40.0	34.2	36.3	42.3	38.2	38.7	36.9	37.6	39.1
Job leavers	7.2	8.7	10.1	7.1	8.6	8.8	9.5	9.8	10.1
Reentrants	23.3	26.3	24.7	22.7	25.1	26.1	25.6	24.2	24.4
New entrants	14.6	18.8	18.3	11.6	13.8	13.8	14.0	14.0	12.8
UNEMPLOYED AS A PERCENT OF THE CIVILIAN LABOR FORCE									
Job losers	5.2	3.0	3.6	5.6	4.1	4.0	3.8	3.7	4.0
Job leavers	.7	.6	.8	.7	.7	.7	.7	.7	.8
Reentrants	2.2	2.0	1.9	2.2	2.0	2.0	1.9	1.7	1.8
New entrants	1.4	1.4	1.2	1.1	1.1	1.1	1.0	1.0	1.0

Table A-9. Unemployed persons by sex and age, seasonally adjusted

Sex and age	Number of unemployed persons (in thousands)			Unemployment rates[1]					
	July 1983	June 1984	July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984	July 1984
Total, 16 years and over	10,600	8,130	8,543	9.5	7.8	7.8	7.5	7.1	7.5
16 to 24 years	4,096	3,156	3,276	18.8	14.4	14.6	14.0	13.0	13.6
16 to 19 years	1,859	1,419	1,464	22.7	19.9	19.4	19.0	17.6	18.3
16 to 17 years	767	602	626	25.1	23.1	22.3	20.2	19.7	20.5
18 to 19 years	1,071	813	817	20.8	18.1	17.5	18.2	16.3	16.7
20 to 24 years	2,237	1,737	1,812	13.9	11.6	12.2	11.5	10.7	11.3
25 years and over	6,486	4,996	5,257	7.4	5.9	6.0	5.7	5.6	5.9
25 to 54 years	5,707	4,274	4,619	7.9	6.3	6.3	6.0	5.7	6.2
55 years and over	798	683	660	5.3	4.3	4.2	4.4	4.6	4.9
Men, 16 years and over	6,248	4,529	4,756	9.9	7.7	7.7	7.3	7.1	7.5
16 to 24 years	2,397	1,772	1,846	18.4	14.6	15.0	14.0	13.7	14.6
16 to 19 years	1,031	774	850	23.8	20.0	19.7	19.4	18.5	20.6
16 to 17 years	451	365	358	27.3	23.0	23.7	21.3	22.7	23.0
18 to 19 years	568	413	478	21.2	18.2	17.3	18.3	16.1	18.8
20 to 24 years	1,366	998	996	15.8	11.9	12.7	11.5	11.4	11.7
25 years and over	3,826	2,757	2,896	7.6	5.9	5.9	5.7	5.4	5.7
25 to 54 years	3,337	2,377	2,496	8.1	6.1	6.2	5.9	5.6	5.9
55 years and over	489	378	401	5.5	4.6	4.4	4.5	4.3	4.6
Women, 16 years and over	4,352	3,600	3,787	9.0	7.9	7.9	7.7	7.2	7.4
16 to 24 years	1,699	1,384	1,430	15.0	14.2	14.1	14.0	12.2	12.5
16 to 19 years	828	645	614	21.5	19.8	19.0	18.6	16.7	15.9
16 to 17 years	316	237	268	22.6	23.1	20.8	19.0	16.4	17.9
18 to 19 years	513	400	339	20.5	18.1	17.8	18.1	16.5	14.4
20 to 24 years	871	739	816	11.7	11.3	11.6	11.6	9.9	10.8
25 years and over	2,660	2,238	2,361	7.1	6.0	6.0	5.8	5.8	6.1
25 to 54 years	2,370	1,897	2,123	7.6	6.5	6.4	6.1	5.8	6.5
55 years and over	309	305	259	5.1	3.9	3.9	4.3	5.0	4.2

[1] Unemployment as a percent of the civilian labor force.

Table A-10. Employment status of black and other workers

(Numbers in thousands)

Employment status	Not seasonally adjusted			Seasonally adjusted[1]					
	July 1983	June 1984	July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984	July 1984
Civilian noninstitutional population	23,347	23,989	24,154	23,347	23,539	23,791	23,894	23,989	24,154
Civilian labor force	15,069	15,303	15,710	14,577	14,521	14,770	14,976	15,039	15,196
Participation rate	64.5	63.8	65.0	62.4	61.7	62.1	62.7	62.7	62.9
Employed	12,261	13,040	13,227	11,969	12,325	12,541	12,852	13,020	12,907
Employment-population ratio[2]	52.5	54.4	54.8	51.3	52.4	52.7	53.8	54.3	53.4
Unemployed	2,808	2,263	2,483	2,608	2,195	2,229	2,125	2,020	2,290
Unemployment rate	18.6	14.8	15.8	17.9	15.1	15.1	14.2	13.4	15.1
Not in labor force	8,277	8,686	8,444	8,770	9,018	9,021	8,918	8,950	8,958

[1] The population figures are not adjusted for seasonal variation; therefore, identical numbers appear in the unadjusted and seasonally adjusted columns.

[2] Civilian employment as a percent of the civilian noninstitutional population.

Table A-11. Occupational status of the employed and unemployed, not seasonally adjusted

(Numbers in thousands)

Occupation	Civilian employed		Unemployed		Unemployment rate	
	July 1983	July 1984	July 1983	July 1984	July 1983	July 1984
Total, 15 years and over[1]	103,273	107,484	10,707	8,714	9.4	7.5
Managerial and professional specialty	23,166	24,423	867	754	3.6	3.0
Executive, administrative, and managerial	10,740	11,744	389	327	3.5	2.7
Professional specialty	12,425	12,679	478	428	3.7	3.3
Technical, sales, and administrative support	31,787	33,337	2,138	1,664	6.3	4.8
Technicians and related support	3,142	3,249	156	95	4.7	2.8
Sales occupations	12,060	12,961	842	654	6.5	4.8
Administrative support, including clerical	16,586	17,128	1,140	915	6.4	5.1
Service occupations	14,155	14,525	1,657	1,466	10.5	9.2
Private household	1,006	1,039	85	83	7.8	7.4
Protective service	1,761	1,734	135	91	7.1	5.0
Service, except private household and protective	11,387	11,751	1,437	1,292	11.2	9.9
Precision production, craft, and repair	12,831	13,665	1,334	962	9.4	6.7
Mechanics and repairers	4,171	4,399	334	200	7.4	4.4
Construction trades	4,632	4,834	612	491	11.7	9.2
Other precision production, craft, and repair	4,028	4,212	388	270	8.8	6.0
Operators, fabricators, and laborers	16,591	17,338	2,718	2,088	14.1	10.8
Machine operators, assemblers, and inspectors	7,772	7,979	1,293	916	14.3	10.3
Transportation and material moving occupations	4,260	4,572	523	388	10.9	7.8
Handlers, equipment cleaners, helpers, and laborers	4,558	4,787	902	787	16.5	14.1
Construction laborers	707	854	165	183	18.9	17.6
Other handlers, equipment cleaners, helpers, and laborers	3,851	3,933	737	604	16.1	13.3
Farming, forestry, and fishing	4,743	4,416	379	283	7.4	6.0

[1] Persons with no previous work experience and those whose last job was in the Armed Forces are included in the unemployed total.

HOUSEHOLD DATA

Table A-12. Employment status of male Vietnam-era veterans and nonveterans by age, not seasonally adjusted

[Numbers in thousands]

Veteran status and age	Civilian noninstitutional population		Civilian labor force							
			Total		Employed		Unemployed			
							Number		Percent of labor force	
	July 1983	July 1984	July 1983	July 1984	July 1983	July 1984	July 1983	July 1984	July 1983	July 1984
VETERANS										
Total, 25 years and over	7,846	7,919	7,378	7,474	6,763	7,046	615	428	8.3	5.7
25 to 39 years	5,846	5,480	5,613	5,301	5,104	4,970	509	331	9.1	6.2
25 to 29 years	668	469	620	445	544	399	76	46	12.3	10.3
30 to 34 years	2,135	1,711	2,055	1,658	1,868	1,542	207	116	10.1	7.0
35 to 39 years	3,043	3,300	2,938	3,198	2,712	3,029	226	169	7.7	5.3
40 years and over	2,000	2,439	1,765	2,173	1,659	2,076	106	97	6.0	4.5
NONVETERANS										
Total, 25 to 39 years	20,053	21,152	18,943	20,026	17,350	18,816	1,593	1,210	8.4	6.0
25 to 29 years	8,713	8,973	8,176	8,466	7,408	7,907	768	559	9.4	6.6
30 to 34 years	6,808	7,419	6,469	7,060	5,967	6,653	502	407	7.8	5.8
35 to 39 years	4,532	4,760	4,298	4,500	3,975	4,256	323	244	7.5	5.4

NOTE: Male Vietnam-era veterans are men who served in the Armed Forces between August 5, 1964 and May 7, 1975. Nonveterans are men who have never served in the Armed Forces; published data are limited to those 25 to 39 years of age, the group that most closely corresponds to the bulk of the Vietnam-era veteran population.

HOUSEHOLD DATA

Table A-13. Employment status of the civilian population for ten large States

[Numbers in thousands]

State and employment status	Not seasonally adjusted[1]			Seasonally adjusted[1]					
	July 1983	June 1984	July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984	July 1984
California									
Civilian noninstitutional population	18,822	19,116	19,143	18,822	19,035	19,061	19,088	19,116	19,143
Civilian labor force	12,431	12,699	12,800	12,320	12,451	12,458	12,490	12,693	12,646
Employed	11,268	11,759	11,728	11,169	11,425	11,504	11,524	11,726	11,610
Unemployed	1,183	941	1,072	1,151	1,026	954	966	957	1,036
Unemployment rate	9.5	7.4	8.4	9.3	8.2	7.7	7.7	7.5	8.2
Florida									
Civilian noninstitutional population	8,344	8,347	8,366	8,344	8,491	8,509	8,528	8,547	8,366
Civilian labor force	5,006	5,067	5,162	4,917	5,105	5,004	5,058	5,020	5,080
Employed	4,598	4,731	4,811	4,499	4,826	4,694	4,735	4,682	4,723
Unemployed	408	336	351	418	279	310	323	338	357
Unemployment rate	8.2	6.6	6.8	8.5	5.5	6.2	6.4	6.7	7.0
Illinois									
Civilian noninstitutional population	8,579	8,596	8,597	8,579	8,591	8,593	8,594	8,596	8,597
Civilian labor force	5,676	5,736	5,666	5,553	5,625	5,579	5,617	5,658	5,538
Employed	5,011	5,230	5,176	4,922	5,036	5,021	5,108	5,192	5,080
Unemployed	665	506	489	631	589	558	509	466	458
Unemployment rate	11.7	8.8	8.6	11.4	10.5	10.0	9.1	8.2	8.3
Massachusetts									
Civilian noninstitutional population	4,488	4,509	4,511	4,488	4,503	4,505	4,507	4,509	4,511
Civilian labor force	3,029	3,084	3,094	2,980	3,026	3,089	3,057	3,061	3,041
Employed	2,841	2,946	2,919	2,799	2,865	2,932	2,933	2,943	2,912
Unemployed	189	138	176	181	161	167	124	118	129
Unemployment rate	6.2	4.5	4.9	6.1	5.3	5.4	4.1	3.9	4.2
Michigan									
Civilian noninstitutional population	6,747	6,726	6,724	6,747	6,731	6,729	6,727	6,726	6,724
Civilian labor force	4,419	4,451	4,480	4,308	4,385	4,377	4,356	4,365	4,358
Employed	3,842	3,949	3,975	3,733	3,891	3,911	3,845	3,860	3,856
Unemployed	577	503	506	575	494	466	511	505	502
Unemployment rate	13.1	11.3	11.3	13.3	11.3	10.6	11.7	11.6	11.5
New Jersey									
Civilian noninstitutional population	5,754	5,794	5,798	5,754	5,783	5,786	5,790	5,794	5,798
Civilian labor force	3,739	3,825	3,880	3,659	3,822	3,928	3,861	3,777	3,812
Employed	3,430	3,623	3,635	3,355	3,565	3,661	3,639	3,585	3,564
Unemployed	310	202	245	304	257	267	222	192	248
Unemployment rate	8.3	5.3	6.3	8.3	6.7	6.8	5.7	5.1	6.5
New York									
Civilian noninstitutional population	13,577	13,628	13,633	13,577	13,619	13,614	13,622	13,628	13,633
Civilian labor force	8,398	8,070	8,341	8,148	8,061	7,996	8,074	7,972	8,107
Employed	7,667	7,487	7,661	7,448	7,501	7,461	7,532	7,403	7,460
Unemployed	731	583	680	700	560	535	542	569	647
Unemployment rate	8.7	7.2	8.2	8.6	6.9	6.7	6.7	7.1	8.0
Ohio									
Civilian noninstitutional population	8,050	8,050	8,050	8,050	8,050	8,049	8,050	8,050	8,050
Civilian labor force	5,287	5,183	5,292	5,139	5,025	5,050	5,081	5,072	5,141
Employed	4,710	4,715	4,845	4,572	4,513	4,543	4,562	4,616	4,695
Unemployed	577	469	447	567	512	507	519	456	446
Unemployment rate	10.9	9.0	8.4	11.0	10.2	10.0	10.2	9.0	8.7
Pennsylvania									
Civilian noninstitutional population	9,187	9,208	9,210	9,187	9,202	9,203	9,205	9,208	9,210
Civilian labor force	5,687	5,640	5,678	5,576	5,365	5,394	5,497	5,381	5,542
Employed	5,068	5,122	5,138	4,954	4,887	4,900	4,995	5,102	4,995
Unemployed	619	518	540	622	478	494	502	479	547
Unemployment rate	10.9	9.2	9.5	11.3	8.9	9.2	9.1	8.6	9.9
Texas									
Civilian noninstitutional population	11,273	11,359	11,385	11,273	11,480	11,506	11,532	11,559	11,385
Civilian labor force	7,716	8,090	8,186	7,646	7,817	7,854	7,988	8,011	8,097
Employed	7,079	7,646	7,670	7,036	7,307	7,322	7,531	7,629	7,602
Unemployed	637	445	516	610	510	533	457	382	495
Unemployment rate	8.3	5.5	6.3	8.0	6.5	6.8	5.7	4.8	6.1

[1] These are the official Bureau of Labor Statistics' estimates used in the administration of Federal fund allocation programs.

[1] The population figures are not adjusted for seasonal variation; therefore, identical numbers appear in the unadjusted and the seasonally adjusted columns.

ESTABLISHMENT DATA

Table B-1. Employees on nonagricultural payrolls by industry

(In thousands)

Industry	Not seasonally adjusted				Seasonally adjusted					
	July 1983	May 1984	June 1984[p]	July 1984[p]	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984[p]	July 1984[p]
Total	90,112	94,146	94,948	94,264	90,274	93,058	93,449	93,788	94,076	94,378
Total private	75,001	77,913	78,938	79,056	74,452	77,183	77,546	77,864	78,203	78,448
Goods-producing	23,608	24,866	25,315	25,353	23,414	24,593	24,760	24,851	24,989	25,126
Mining	939	993	1,013	1,016	946	978	984	995	1,002	1,002
Oil and gas extraction	596.3	613.1	627.2	630.7	590	607	612	619	623	625
Construction	4,185	4,299	4,522	4,647	3,947	4,131	4,246	4,286	4,348	4,380
General building contractors	1,094.7	1,121.9	1,185.8	1,216.2	1,024	1,099	1,110	1,126	1,138	1,137
Manufacturing	18,464	19,534	19,780	19,690	18,521	19,466	19,530	19,570	19,639	19,744
Production workers	12,527	13,459	13,624	13,521	12,612	13,388	13,443	13,465	13,504	13,600
Durable goods	10,761	11,621	11,759	11,715	10,781	11,513	11,551	11,598	11,661	11,730
Production workers	7,138	7,861	7,956	7,897	7,165	7,769	7,799	7,826	7,866	7,933
Lumber and wood products	685.9	713.5	735.2	731.3	665	712	714	711	716	709
Furniture and fixtures	442.8	480.5	483.4	475.1	454	483	482	482	484	487
Stone, clay, and glass products	585.7	608.9	620.2	622.4	573	606	604	605	606	608
Primary metal industries	835.4	891.3	894.6	886.5	838	877	879	887	885	888
Blast furnaces and basic steel products	346.9	350.5	350.8	346.0	344	347	345	347	345	343
Fabricated metal products	1,356.3	1,468.7	1,488.1	1,475.3	1,369	1,456	1,459	1,469	1,479	1,480
Machinery, except electrical	2,027.8	2,207.6	2,233.2	2,235.0	2,039	2,166	2,189	2,203	2,227	2,246
Electrical and electronic equipment	2,018.5	2,223.1	2,252.4	2,256.6	2,024	2,202	2,213	2,228	2,239	2,241
Transportation equipment	1,751.9	1,921.6	1,934.6	1,921.7	1,757	1,905	1,905	1,906	1,919	1,926
Motor vehicles and equipment	755.9	864.5	870.4	858.7	736	863	857	848	855	857
Instruments and related products	690.2	720.6	727.5	729.2	690	718	719	722	723	729
Miscellaneous manufacturing	366.1	385.1	389.3	381.4	372	388	388	385	385	387
Nondurable goods	7,703	7,933	8,021	7,975	7,740	7,953	7,979	7,972	7,978	8,014
Production workers	5,401	5,598	5,668	5,624	5,447	5,619	5,644	5,639	5,638	5,667
Food and kindred products	1,658.0	1,599.1	1,639.8	1,681.8	1,626	1,638	1,648	1,643	1,646	1,649
Tobacco manufactures	63.9	61.9	62.3	61.6	69	66	67	67	66	66
Textile mill products	732.5	763.2	763.6	745.8	745	769	766	762	760	759
Apparel and other textile products	1,130.8	1,222.0	1,226.4	1,180.4	1,171	1,218	1,226	1,217	1,208	1,222
Paper and allied products	662.0	680.1	691.3	689.2	661	680	680	681	684	689
Printing and publishing	1,292.2	1,354.2	1,361.1	1,359.8	1,297	1,339	1,348	1,356	1,361	1,365
Chemicals and allied products	1,051.9	1,058.5	1,071.2	1,068.9	1,046	1,054	1,057	1,057	1,063	1,063
Petroleum and coal products	198.9	188.6	190.2	190.5	195	190	189	188	188	187
Rubber and miscellaneous plastics products	717.0	797.8	806.0	798.9	723	790	790	793	796	805
Leather and leather products	195.7	207.3	209.0	197.7	207	209	208	206	204	209
Service-producing	66,504	69,300	69,633	68,911	66,860	68,463	68,689	68,917	69,087	69,252
Transportation and public utilities	5,028	5,145	5,200	5,199	5,001	5,112	5,129	5,144	5,151	5,179
Transportation	2,750	2,877	2,917	2,912	2,731	2,839	2,862	2,871	2,882	2,912
Communication and public utilities	2,278	2,268	2,283	2,287	2,250	2,273	2,267	2,273	2,269	2,267
Wholesale trade	5,285	5,485	5,537	5,542	5,256	5,457	5,473	5,492	5,501	5,511
Durable goods	3,069	3,235	3,270	3,274	3,057	3,205	3,215	3,235	3,250	3,261
Nondurable goods	2,216	2,250	2,267	2,268	2,199	2,252	2,258	2,257	2,251	2,250
Retail trade	13,635	14,164	14,348	14,329	15,580	14,030	14,093	14,164	14,234	14,264
General merchandise stores	2,116.4	2,200.0	2,231.9	2,242.3	2,164	2,230	2,231	2,273	2,291	2,290
Food stores	2,562.9	2,619.0	2,644.3	2,649.3	2,558	2,626	2,633	2,630	2,639	2,644
Automotive dealers and service stations	1,690.3	1,754.2	1,770.4	1,779.6	1,673	1,748	1,743	1,751	1,751	1,760
Eating and drinking places	5,157.7	5,292.0	5,381.1	5,353.8	5,025	5,136	5,134	5,183	5,199	5,213
Finance, insurance, and real estate	5,353	5,440	5,721	5,755	5,478	5,613	5,640	5,643	5,676	5,677
Finance	2,778	2,834	2,846	2,882	2,749	2,831	2,851	2,843	2,860	2,860
Insurance	1,727	1,746	1,757	1,764	1,719	1,741	1,743	1,746	1,752	1,755
Real estate	1,054	1,060	1,098	1,109	1,010	1,041	1,047	1,053	1,064	1,062
Services	19,901	20,631	20,817	20,870	19,723	20,378	20,449	20,549	20,652	20,692
Business services	3,592.9	3,959.3	4,024.9	4,056.3	3,577	3,873	3,912	3,979	4,013	4,036
Health services	6,012.3	6,054.7	6,089.3	6,118.0	5,981	6,052	6,062	6,073	6,065	6,088
Government	15,111	16,233	16,010	15,208	15,822	15,873	15,903	15,904	15,873	15,931
Federal	2,797	2,770	2,809	2,820	2,744	2,770	2,771	2,767	2,765	2,767
State	3,475	3,751	3,584	3,506	3,662	3,686	3,693	3,699	3,680	3,695
Local	8,839	9,713	9,617	8,882	9,416	9,417	9,439	9,438	9,428	9,469

p = preliminary.

ESTABLISHMENT DATA

Table B-2. Average weekly hours of production or nonsupervisory workers[1] on private nonagricultural payrolls by industry

Industry	Not seasonally adjusted				Seasonally adjusted					
	July 1983	May 1984	June 1984 p	July 1984 p	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984 p	July 1984 p
Total private	35.3	35.2	35.5	35.7	35.0	35.3	35.4	35.3	35.3	35.3
Mining	42.1	43.2	43.5	43.2	(2)	(2)	(2)	(2)	(2)	(2)
Construction	38.2	38.2	38.7	38.7	(2)	(2)	(2)	(2)	(2)	(2)
Manufacturing	40.0	40.6	40.8	40.4	40.2	40.7	41.1	40.6	40.5	40.6
Overtime hours	3.0	3.3	3.4	3.4	3.0	3.5	3.7	3.3	3.3	3.4
Durable goods	40.4	41.4	41.5	41.0	40.8	41.4	41.8	41.3	41.2	41.4
Overtime hours	2.9	3.5	3.6	3.5	3.0	3.7	4.0	3.5	3.5	3.6
Lumber and wood products	40.2	40.1	40.3	39.6	40.0	40.1	40.4	39.6	39.4	39.4
Furniture and fixtures	39.0	39.5	39.6	39.1	39.7	39.6	39.7	39.7	39.1	39.7
Stone, clay, and glass products	41.9	42.4	42.4	42.2	41.6	41.9	42.3	42.1	41.7	41.9
Primary metal industries	40.5	41.9	42.0	41.6	40.7	41.8	42.2	42.1	41.8	41.8
Blast furnaces and basic steel products	40.2	41.3	41.4	41.1	39.9	41.2	41.0	41.6	41.3	40.7
Fabricated metal products	40.2	41.4	41.6	40.8	40.7	41.3	41.8	41.4	41.3	41.3
Machinery, except electrical	40.1	41.8	42.0	41.4	40.6	41.9	42.3	41.9	42.0	41.9
Electrical and electronic equipment	40.3	40.9	41.0	40.7	40.7	41.0	41.3	41.0	40.8	41.1
Transportation equipment	41.7	42.7	42.8	42.3	42.0	42.9	43.5	42.4	42.5	42.6
Motor vehicles and equipment	43.0	43.7	44.0	43.3	42.9	44.4	44.8	43.9	43.1	43.1
Instruments and related products	40.1	40.7	41.2	40.7	40.5	41.1	41.4	40.7	41.2	41.1
Miscellaneous manufacturing	38.7	39.3	39.1	39.1	(2)	(2)	(2)	(2)	(2)	(2)
Nondurable goods	39.4	39.6	39.8	39.8	39.5	39.8	40.2	39.6	39.6	39.5
Overtime hours	3.0	3.0	3.1	3.1	3.0	3.3	3.4	3.1	3.1	3.1
Food and kindred products	39.5	39.6	40.0	39.8	39.4	39.8	40.1	39.7	39.8	39.7
Tobacco manufactures	36.8	39.6	41.0	38.9	(2)	(2)	(2)	(2)	(2)	(2)
Textile mill products	40.2	40.1	40.3	39.1	40.8	40.6	41.2	40.0	39.9	39.6
Apparel and other textile products	36.1	36.5	36.8	36.2	35.9	36.7	37.4	36.5	36.4	36.0
Paper and allied products	42.7	42.9	43.1	43.1	42.9	43.0	43.2	43.1	42.9	43.2
Printing and publishing	37.5	37.8	37.6	37.7	37.6	37.9	38.2	38.0	37.7	37.8
Chemicals and allied products	41.6	41.8	42.1	41.6	41.8	42.0	42.0	41.8	42.0	41.8
Petroleum and coal products	44.3	43.6	43.5	43.5	43.8	44.7	43.7	43.5	43.1	43.0
Rubber and miscellaneous plastics products	40.9	41.7	41.8	41.2	(2)	(2)	(2)	(2)	(2)	(2)
Leather and leather products	37.4	36.9	37.5	36.7	37.2	36.7	37.5	36.5	36.5	36.4
Transportation and public utilities	39.2	39.2	39.1	39.6	39.0	39.2	39.5	39.4	39.5	39.6
Wholesale trade	38.6	38.6	38.1	38.8	38.4	38.5	38.7	38.6	38.6	38.6
Retail trade	30.6	30.0	30.4	30.8	29.8	30.1	30.0	30.1	30.2	30.0
Finance, insurance, and real estate	36.3	36.3	36.3	36.6	(2)	(2)	(2)	(2)	(2)	(2)
Services	33.1	32.6	32.9	33.2	32.7	32.8	32.8	32.7	32.7	32.8

[1] Data relate to production workers in mining and manufacturing; to construction workers in construction; and to nonsupervisory workers in transportation and public utilities; wholesale and retail trade; finance, insurance, and real estate; and services. These groups account for approximately four-fifths of the total employees on private nonagricultural payrolls.

[2] This series is not published seasonally adjusted since the seasonal component is small relative to the trend-cycle and/or irregular components and consequently cannot be separated with sufficient precision.

p = preliminary.

ESTABLISHMENT DATA

Table B-3. Average hourly and weekly earnings of production or nonsupervisory workers[1] on private nonagricultural payrolls by industry

Industry	Average hourly earnings				Average weekly earnings			
	July 1983	May 1984	June 1984 p	July 1984 p	July 1983	May 1984	June 1984 p	July 1984 p
Total private	$8.01	$8.28	$8.30	$8.34	$282.75	$291.46	$294.65	$297.74
Seasonally adjusted	8.04	8.29	8.33	8.37	281.40	292.64	296.05	295.46
Mining	11.27	11.56	11.58	11.62	474.47	499.39	503.73	501.98
Construction	11.80	11.99	11.94	11.97	450.76	458.02	462.08	463.24
Manufacturing	8.84	9.11	9.14	9.17	353.60	369.87	372.91	370.47
Durable goods	9.38	9.66	9.69	9.70	378.95	399.92	402.14	397.70
Lumber and wood products	7.82	7.92	8.02	8.01	314.36	317.59	323.21	317.10
Furniture and fixtures	6.65	6.80	6.85	6.86	259.35	268.60	271.36	268.23
Stone, clay, and glass products	9.33	9.54	9.57	9.63	390.93	404.50	405.77	406.39
Primary metal industries	11.37	11.49	11.47	11.46	460.49	481.43	481.74	476.74
Blast furnaces and basic steel products	12.81	13.09	13.03	12.99	514.96	540.62	539.44	533.89
Fabricated metal products	9.07	9.33	9.32	9.35	364.61	386.26	387.71	381.48
Machinery, except electrical	9.57	9.70	9.94	9.92	383.76	413.82	417.48	410.69
Electrical and electronic equipment	6.57	8.69	8.91	8.94	349.40	363.60	365.31	363.86
Transportation equipment	11.60	12.04	12.13	12.13	483.72	514.11	519.16	513.10
Motor vehicles and equipment	12.05	12.51	12.67	12.67	518.15	546.69	557.48	548.61
Instruments and related products	8.49	8.71	8.77	8.79	340.45	354.50	361.32	357.75
Miscellaneous manufacturing	6.80	6.99	6.98	7.01	263.16	274.71	272.92	274.09
Nondurable goods	8.12	8.30	8.33	8.41	319.93	328.68	331.53	331.35
Food and kindred products	8.20	8.43	8.44	8.45	323.90	333.83	337.60	336.31
Tobacco manufactures	10.90	11.55	11.93	11.68	401.12	457.38	489.13	454.35
Textile mill products	6.17	6.42	6.44	6.43	248.03	257.44	259.53	251.41
Apparel and other textile products	5.35	5.48	5.51	5.51	195.14	200.02	202.77	199.46
Paper and allied products	10.07	10.34	10.42	10.53	429.99	443.59	449.10	453.84
Printing and publishing	9.09	9.31	9.29	9.35	340.88	351.92	349.30	352.50
Chemicals and allied products	10.59	11.02	11.05	11.14	440.34	460.64	465.21	463.42
Petroleum and coal products	13.22	13.32	13.33	13.49	585.65	580.75	579.86	586.82
Rubber and miscellaneous plastics products	8.02	8.20	8.24	8.31	328.02	341.94	344.43	342.37
Leather and leather products	5.53	5.68	5.68	5.71	206.82	209.59	213.00	209.56
Transportation and public utilities	10.84	11.03	11.08	11.23	424.93	432.38	439.88	446.95
Wholesale trade	8.56	8.86	8.89	8.98	330.42	342.00	344.04	348.42
Retail trade	5.73	5.88	5.87	5.87	175.36	176.40	178.45	180.80
Finance, insurance, and real estate	7.29	7.55	7.57	7.63	264.63	274.07	274.79	279.26
Services	7.24	7.55	7.54	7.59	239.64	246.13	248.07	251.99

[1] See footnote 1, table B-2.

p = preliminary.

Table B-4. Hourly Earnings Index for production or nonsupervisory workers[1] on private nonagricultural payrolls by industry

(1977 = 100)

Industry	Not seasonally adjusted					Seasonally adjusted						
	July 1983	May 1984	June 1984p	July 1984p	Percent change from: July 1983-July 1984	July 1983	Mar. 1984	Apr. 1984	May 1984	June 1984p	July 1984p	Percent change from: June 1984-July 1984
Total private workers:												
Current dollars	155.3	159.6	159.9	160.7	3.5	155.6	159.1	159.9	159.6	160.3	161.1	0.5
Constant (1977) dollars	94.5	94.8	94.8	N.A.	(2)	94.9	95.1	95.4	94.9	95.2	N.A.	(3)
Mining	167.5	172.5	173.7	174.9	4.4	(4)	(4)	(4)	(4)	(4)	(4)	(4)
Construction	144.4	146.3	146.2	146.4	1.4	144.5	146.3	146.6	147.0	147.2	146.6	-.4
Manufacturing	157.9	161.8	162.2	162.6	3.0	157.9	161.2	161.6	162.0	162.3	162.6	.2
Transportation and public utilities	156.9	160.2	160.8	162.7	3.7	157.9	160.9	161.3	160.9	162.3	163.7	.9
Wholesale trade	158.6	164.1	164.5	166.0	4.7	(4)	(4)	(4)	(4)	(4)	(4)	(4)
Retail trade	150.5	154.0	153.9	153.9	2.2	150.7	153.2	153.7	153.4	153.8	154.0	.2
Finance, insurance, and real estate	158.9	164.2	164.7	166.2	4.6	158.9	164.2	165.8	164.2	164.7	166.2	.9
Services	155.3	161.6	161.7	163.0	5.0	156.4	160.8	162.5	161.4	162.6	164.2	.9

1 See footnote 1, table B-2.
2 Percent change is .3 percent from June 1983 to June 1984, the latest month available.
3 Percent change is .3 percent from May 1984 to June 1984, the latest month available.
4 These series are not seasonally adjusted since the seasonal component is small relative to the trend-cycle and/or irregular components and consequently cannot be separated with sufficient precision.

N.A. = not available.
p = preliminary.

ESTABLISHMENT DATA

Table B-5. Indexes of aggregate weekly hours of production or nonsupervisory workers[1] on private nonagricultural payrolls by industry

(1977 = 100)

Industry	Not seasonally adjusted				Seasonally adjusted					
	July 1983	May 1984	June 1984 p	July 1984 p	July 1983	Nov. 1984	Apr. 1984	May 1984	June 1984 p	July 1984 p
Total	107.9	112.0	114.5	115.0	106.1	110.9	112.0	112.0	112.6	112.9
Goods-producing	92.4	99.7	101.3	101.7	91.6	98.1	100.1	99.5	100.0	100.6
Mining	106.8	114.3	117.6	117.4	103.7	111.7	114.7	115.5	116.2	116.5
Construction	112.6	115.7	124.6	128.7	102.0	107.7	112.6	113.7	116.9	116.4
Manufacturing	87.9	93.9	97.5	95.7	88.9	95.7	97.0	96.0	96.0	96.8
Durable goods	84.6	95.5	97.0	95.1	85.8	94.5	95.8	95.0	95.2	96.3
Lumber and wood products	94.0	97.9	101.6	99.5	90.4	97.8	98.6	96.1	96.0	95.5
Furniture and fixtures	91.7	101.6	102.5	99.3	96.2	102.8	103.1	102.5	101.5	103.6
Stone, clay, and glass products	85.3	90.1	92.3	92.3	83.6	88.2	89.2	89.0	88.3	89.3
Primary metal industries	64.1	73.0	75.3	73.6	66.8	73.2	74.1	74.8	73.9	74.5
Blast furnaces and basic steel products	59.8	64.0	64.1	62.4	59.0	62.6	62.5	63.7	62.7	61.3
Fabricated metal products	80.3	91.4	93.2	90.5	82.5	89.9	91.5	91.3	91.8	92.5
Machinery, except electrical	80.7	95.3	97.0	95.4	82.6	93.3	95.2	95.3	96.5	97.6
Electrical and electronic equipment	98.4	113.0	114.5	114.3	100.3	112.2	113.6	113.2	113.2	116.3
Transportation equipment	83.2	96.1	96.7	93.7	84.9	95.5	96.8	94.1	94.5	95.4
Motor vehicles and equipment	75.5	90.4	91.4	87.4	75.9	91.8	91.8	86.3	87.2	87.5
Instruments and related products	101.2	107.9	110.1	109.9	102.4	108.8	109.3	107.7	109.3	109.3
Miscellaneous manufacturing	78.7	83.0	85.9	84.0	81.0	85.8	86.5	85.3	84.6	86.4
Nondurable goods	92.7	96.6	98.4	96.6	93.6	97.4	98.8	97.4	97.2	97.4
Food and kindred products	97.8	93.7	97.8	100.7	95.3	97.1	98.7	97.7	98.2	98.2
Tobacco manufactures	81.6	83.5	87.5	74.8	90.4	87.6	93.4	92.0	93.1	84.6
Textile mill products	79.3	82.8	83.3	78.8	82.0	84.3	85.7	82.7	82.2	81.2
Apparel and other textile products	85.7	94.2	95.3	89.9	88.5	94.2	96.7	93.9	92.3	92.8
Paper and allied products	95.3	98.7	101.0	100.6	95.6	99.1	99.6	99.3	99.5	100.7
Printing and publishing	108.2	116.1	115.8	115.7	109.7	114.6	116.6	118.6	116.5	117.1
Chemicals and allied products	94.3	95.8	97.9	96.5	94.3	96.1	96.2	95.8	96.7	96.6
Petroleum and coal products	95.3	84.3	86.9	88.0	92.1	88.4	86.5	86.1	84.5	85.1
Rubber and miscellaneous plastics products	99.2	113.5	115.2	112.1	101.4	112.2	113.8	113.1	113.2	114.5
Leather and leather products	75.8	79.5	81.3	75.0	79.8	79.7	81.4	78.3	77.4	78.6
Service-producing	116.5	118.8	121.2	122.4	114.1	117.9	118.6	119.0	119.6	119.8
Transportation and public utilities	101.3	104.0	106.5	106.8	100.4	103.1	104.4	104.3	104.8	105.9
Wholesale trade	108.9	113.3	114.8	113.1	107.7	112.5	113.3	113.5	113.7	113.9
Retail trade	109.3	110.5	113.3	114.5	106.1	109.9	110.3	111.1	111.9	111.2
Finance, insurance, and real estate	121.5	123.2	125.0	127.0	119.2	122.2	123.1	123.1	124.0	124.4
Services	129.3	131.9	134.3	135.8	126.5	130.9	131.4	131.7	132.2	132.7

[1] See footnote 1, table B-2.

p = preliminary.

Table B-6. Indexes of diffusion: Percent of industries in which employment[1] increased

Time span	Year	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Over 1-month span	1982	27.6	47.6	35.7	31.1	41.1	33.5	34.6	32.4	37.3	28.9	32.4	45.7
	1983	54.3	46.5	60.8	68.9	69.5	64.6	74.3	68.6	69.5	75.4	69.7	73.6
	1984	71.1	73.2	67.0	63.8	64.1	64.1p	64.2p					
Over 3-month span	1982	25.1	27.8	27.8	27.3	27.6	28.6	23.5	24.1	26.5	25.9	27.8	41.6
	1983	46.8	57.3	64.1	75.1	75.7	77.8	74.1	81.6	80.6	78.9	79.5	77.6
	1984	81.3	80.5	76.5	71.1	67.8p	73.0p						
Over 6-month span	1982	19.2	22.2	21.9	24.6	20.3	21.4	21.4	18.6	23.2	27.3	29.5	35.4
	1983	30.8	43.0	49.2	75.1	80.0	82.6	84.1	82.4	84.6	85.9	86.8	83.8
	1984	81.9	82.7	80.0p	77.3p								
Over 12-month span	1982	21.6	21.4	17.6	18.1	16.2	18.1	21.1	21.1	25.1	31.4	34.1	40.3
	1983	49.5	54.3	61.9	71.1	77.3	79.3	83.8	88.1	86.8	87.3	85.4	86.2p
	1984	86.3p											

[1] Number of employees, seasonally adjusted for 1, 3, and 6 month spans, on payrolls of 186 private nonagricultural industries.

p = preliminary.

NOTE: Figures are the percent of industries with employment rising. (Half of the unchanged components are counted as rising.) Data are centered within the spans.

Senator JEPSEN. Thank you, Ms. Norwood.

Ms. Norwood, I understand that in January 1985 you will revise the 1984 monthly unemployment rates incorporating new seasonal adjustment factors. Do you expect this to have an effect on the 1984 June and July rates and might these rates turn out to both be, for example, 7.3 percent or somewhere in between as has been experienced in the past?

Ms. NORWOOD. I would expect that the reestimation of the seasonals using full data for the whole year might smooth this just a little bit, but very little. I do not believe that the change in seasonal adjustment will change those numbers very much.

Our regular practice that we use every year is to use the most recent data in seasonally adjusting the numbers. We use the data through December to compute seasonal factors for January to June, and then from July through December we use data through June. I would expect possibly that the June number may be revised upward a tenth or so, but I would expect very little change.

Senator JEPSEN. At last month's hearing, Commissioner, my Democrat colleagues emphasized the difficulty in making accurate seasonal adjustments at this time of year. You commented on this difficulty in your testimony. Why are the summer months so difficult?

Ms. NORWOOD. Largely because every year we have several million youngsters leaving school looking for work. We also have a large number of women who come into the labor market or leave the labor market in some cases. We have teachers who are working during the year and then are not working during the summer. There are a whole set of changes that occur, and basically June, and I believe also January, are probably the hardest months for seasonal adjustment because we have very, very, large seasonal movements. Yet we have to seasonally adjust the data because otherwise we would always show massive increases in employment and unemployment in the month of June when the schools close.

Senator JEPSEN. Ms. Norwood, you state that the unusual strength of the recovery that began in 1982 complicates seasonal adjustment. Would you please explain that in more detail?

Ms. NORWOOD. Yes, I would be glad to try to do that. That's why I included the table attached to my oral statement.

As we know, we passed through a recession that was very steep and quite long, and after that we had a very vigorous recovery. We created during the recovery a very large number of jobs. We have had in the household survey an employment increase of about 6.4 million and in the establishment survey close to 6 million. There are some differences between the surveys in terms of definition and concept, particularly in the treatment of the self-employed, but I think what has happened is that when you have such vigorous growth month after month when you get to the summer months the seasonal adjustment process becomes more difficult.

If you look at this table, last year, before seasonal adjustment, from June to July, we had 1.5 million increase in employment. That's a very large number. In terms of the whole summer change, that 1.5 million was about a third of it.

This year, we have had a change from June to July of about 700,000 increase in employment before seasonal adjustment. If you

look at column 2, you will see that we had a 4.4 million increase last year over the whole summer through July and about a 3.9 million increase this year. The July portion of that change this year is very small. The seasonal adjustment process gives a good deal of weight to the most recent years and I think there, therefore, has probably been an exaggeration in the adjustment of the June numbers as well as perhaps some exaggeration of the July numbers.

Senator JEPSEN. Ms. Norwood, my next two questions are very brief, but they are for the record and in anticipation of what I think some of my colleagues might say and have already alluded to about the end of the expansion and the end of the recovery and so on. I do confess that my old platoon sergeant once told me when I was in the service in the Army, "Don't be asking any questions you don't know the answers to." But this is for the record, I want this on the record.

We have had seven business cycle expansions during the postwar period. In how many of these expansions did the first uptick in unemployment signal the end of the expansion?

Ms. NORWOOD. I don't have that figure in my head offhand, but I would suppose none or very few. It takes several months. You cannot use a single month's data either way to make very strong judgments. We need at least a couple months of data to indicate a change in direction.

Senator JEPSEN. We have checked it and your answer is correct.

Now last, in the entire postwar period, have we ever before had 19 consecutive months without at least one uptick in the unemployment rate? That's one question.

The second question is, have we ever before in the postwar period had 19 consecutive months of increasing employment?

Ms. NORWOOD. No.

Senator JEPSEN. So the answer to the first one, have we ever before had 19 consecutive months without at least uptick in the unemployment rate?

Ms. NORWOOD. No.

Senator JEPSEN. And have we ever had 19 consecutive months of increasing employment before?

Ms. NORWOOD. No.

Senator JEPSEN. Thank you.

Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Madam Commissioner, unemployment is a lagging indicator. It follows other indicators. It's not something that suggests what's going to happen in the future by and large. So this Senator at least isn't going to suggest that the fact that there was a substantial drop in employment or a substantial increase in unemployment in July is going to foretell anything or is going to suggest that the recovery is over. I certainly don't mean to imply that.

Nevertheless, doesn't it seem that the fact that in June and July, taken together, these 2 months, there has been no improvement in unemployment? Doesn't that suggest that the recovery may be slowing down? I'm not saying stopping, but slowing down.

Ms. NORWOOD. There may be some evidence of some slowdown in these data. Again, if we look at July, it looks very much like May. But, as I said, I think the seasonal adjustment problems affect July

as well. If we look at the establishment survey, it has 300,000 growth. That's a bit less than we had for some months of last year, but it is still a pretty hefty growth.

There is, however, some difference in the composition of those employment changes. Some of the industries like lumber and wood manufacturing, furniture manufacturing, and automobiles, which have been increasing their employment rather vigorously are not responsible for much of the change in the business survey this month. Rather, we are seeing change in some of the industries that were very hard hit by the recession and did not show much sign of recovery until recently—industries like machinery and fabricated metals.

So there is some shifting going on there and one might interpret that perhaps as indicating that there's a little bit of slowdown. But I think really we need a little more data to make a definite judgment.

Senator PROXMIRE. Now, of course, I have great faith in you and in your agency and the people who work there and I think you're absolutely right about being careful about the seasonal interpretation, but it seems to me that much—maybe almost all—the seasonal adjustment is taken care of by simply putting these 2 months together.

You, yourself, said let's wait until next month. You said that last time and you've said that before, and if you put them together it means that we have not made progress in reducing unemployment. There is still 8.5 million Americans out of work; isn't that correct; 7.5 percent or 7.4 percent, depending on which comparison you take?

Ms. NORWOOD. That's certainly true, but we do have some improvement in employment. If you take the average of June and July and compare that with the employment level of May, you do have some growth, almost 300,000.

Senator PROXMIRE. In June, the unemployment among blacks fell from 15.8 percent to 15 percent. The jobless rate for black teenagers dropped by nearly 10 percentage points and that was a spectacular improvement. In July, these improvements were all reversed. Overall black unemployment jumped back to 16.9 percent, while the black teenage jobless rate returned to 42.4 percent. More than 40 percent of the black teenagers are out of work.

Has the proportion of blacks with jobs also been falling and do the minorities bear the brunt of the unemployment increase in July?

Ms. NORWOOD. You will recall that at our discussion last month I emphasized that the improvement for black youths was a spectacular change for a single month and was not necessarily likely to stay with us. I think that this month's data have shown that to be fully true. The black population of this country still has very, very real problems in the labor market. There's no question about that. We have had a vigorous recovery and employment for blacks has increased during those 20 months by about 900,000, and unemployment has declined by about 300,000 over the recovery period. But given the problems that the black population has, there is still room for considerable improvement.

You are right in pointing to the employment-population ratios for blacks, particularly our black youth. That figure is really extraordinarily low. It's only about 23 percent. That means that less than one in four black teenagers is working. It's half the employment-population ratio for the white teenagers. There's no question about that and it's been that way for some time.

Senator PROXMIRE. Let me ask what we can foresee for the economy. As I say, I think we all agree that unemployment, by and large, has been a lagging indicator, not a leading indicator. But the leading indicators, which is thought to signal turning points in the business cycle, fell by nine-tenths of 1 percent in June. It was a sharp fall. It's a preliminary figure. It may be revised. But it is the first monthly decline since the trough of the recession in 1982. Among the seven components of the index which contributed to the June decline, two are considered especially sensitive to changes in demand. One is manufacturers' new orders for consumer goods and materials. Of course, they would certainly reflect jobs in the future. And contracts and orders for plant and equipment, another indicator of what jobs are going to be in the future.

Now they indicated that jobs are not going to be as good in the future. Looking at just nondefense industries, recognizing that there's been a growth in defense industries, are these declines even steeper? Do you have any indication of that?

Ms. NORWOOD. No, I don't.

Senator PROXMIRE. Would you gather from this that these indicators do suggest that the pace of recovery is slowing?

Ms. NORWOOD. I think many of the indicators of output for the month of June suggest a slowdown in the rate of recovery—not the end of it, but a slowdown.

Senator PROXMIRE. Now is there more of a slowdown in the interest-sensitive industries?

Ms. NORWOOD. Certainly in housing there has been a real slowdown. That's a very interest-sensitive industry. I don't think there's been much slowdown in auto sales, which is interest sensitive. If you look at our data on employment, we have certainly not had any declines in employment in those industries, but this month there were not any very large increases either, and we had been having very large increases before in those industries.

Senator PROXMIRE. How does manufacturing employment, which is most affected by the business cycle, compare with the levels experienced during the 1981–82 recession and which specific industries have failed to recovery at least as many jobs as were lost during the recession?

Ms. NORWOOD. The percent increase during this recovery has been about 9.3 percent for all employees in manufacturing. That compares very favorably with all other recovery periods except 1949. When we look at the jobs lost during the recession, we find that many industries—and in particular consumer-related industries—are now well above the job levels that they had at the time that the recession began—that is, at the last peak.

Senator PROXMIRE. My question is, which specific industries have lost or at least failed to recover at least as many jobs as were lost in the recession?

Ms. NORWOOD. Well, the consumer-related industries are up. Many of the more basic industries, like primary metals and machinery are still at a very, very low percentage of recovery, as are several of the nondurable goods industries like leather, textiles, chemicals, and petroleum.

Senator PROXMIRE. The chairman has been very tolerant in this round and he's allowed me to ask you one more question. My time is up.

Let me ask you this. In the 10 largest States, unemployment rose sharply in 5—California, New Jersey, New York, Pennsylvania, and Texas. And it remained about the same in the others—Florida, Illinois, Massachusetts, Michigan, and Ohio. The unemployment rates of many of these States also depart considerably from the national average. Michigan still has double-digit unemployment, 11.5 percent. Pennsylvania has 9.9 percent, almost double-digit unemployment. Ohio, Illinois, California, and New York have unemployment rates of 8-percent to 9-percent range and the others have below average jobless rates.

How uneven geographically has the recovery been and do the differences in unemployment primarily reflect differences in the industrial composition of these States, demographic factors, or what are the differences?

Ms. NORWOOD. I think that the most important difference in the employment situation among the States is caused by industrial composition. We have almost a band of States that starts at the Great Lakes and goes all the way down the country through Louisiana, and Mississippi, and Alabama which have high unemployment rates largely because they have the primary metal industries, they have machinery manufacturing, and they have some of the nondurables like textiles and apparel, leather, and shoes that have just not picked up very much.

We have some relatively high unemployment in the Pacific Northwest that tends to be related more to developments in housing. So I think that that has a very important effect and, of course, as we discussed before, certain population groups are disadvantaged and have a harder time in the labor force. In areas where there is a high concentration of disadvantaged groups the unemployment rates may be affected. That isn't usually seen when you look at the State level. You usually have to go below that to individual areas in order to see those comparisons.

Senator PROXMIRE. Thank you.

Thank you, Mr. Chairman.

Senator JEPSEN. Congressman Hawkins.

Representative HAWKINS. Ms. Norwood, I would assume that statistics certainly are means to the end and that they are not an end in themselves. I assume you would agree with that.

Ms. NORWOOD. Yes, sir.

Representative HAWKINS. We shouldn't just deal with statistics on the basis that that solves anything or that is something which we look to as a means of policy decisionmaking only to the extent that we recognize how accurate they may be.

Now the fact is that this month, is it not true, that with the exception of white youth, every segment of the population actually

experienced an increase in unemployment? So it was every group. It wasn't one single group. Would you agree with that?

Ms. NORWOOD. Yes; after seasonal adjustment, those numbers show that.

Representative HAWKINS. Well, I'm a little confused by this sudden interest in seasonal adjustments as if that was a new concept that we have just discovered in July of this year or maybe in June. But isn't it something that has been a practice for a long time to make seasonal adjustments?

Ms. NORWOOD. Yes, sir; and I think if you go back over my past statements in the many years that I have been appearing before this committee, you will find that every June and July I do refer to the problems of seasonal adjustment.

Representative HAWKINS. Yes; that's very, very accurately stated and that's why I'm a little surprised that we suddenly say that because this year a great number of children are out of school and teachers are in the labor market, as if this is something new. Don't these children get out of school annually about this time of the year and isn't it true that teachers leave their jobs and have been leaving their jobs in the past about this same time of the year, and why is it that this suddenly becomes so significant as if we have recently discovered that children leave school this time of the year?

Ms. NORWOOD. Well, you are quite right. We haven't recently discovered it. It is continuing pattern and you are quite right that that's exactly why we seasonally adjust the data.

What I was trying to point out is that the process of seasonal adjustment requires that we use data from a number of years so that we can see what these recurring patterns are. And there are two problems really. One is that sometimes the pattern shifts. Schools may let out earlier than they did in preceding years. The second problem is that when you are in either a very steep recession or a very rigorous recovery, the changes may be dampered or amplified and that may affect the technical process of seasonal adjustment and, therefore, may cause some exaggeration in some of the numbers.

Representative HAWKINS. Do you have any evidence that those unusual things occurred this year or in this month?

Ms. NORWOOD. As I've tried to point out in my statement, before seasonal adjustment employment grew from June to July this year by only half the amount it had grown in July of the previous year. Since the seasonal adjustment process gives the preceding year more weight than other years, the preceding year will have a considerable effect on the seasonally adjusted figures for this year.

Representative HAWKINS. Well, I think we can generally agree that perhaps we shouldn't take any 1 month and look upon that as the basis upon which we make policy decisions. Certainly it should be on a quarterly basis and possibly even on an annual basis.

Now sweeping aside that theoretical conclusion, aren't we faced today with a tragic waste of human beings in that we have over 8 million which you officially count as unemployed, and you should add to that the number that you refer to as the full-time equivalent of those who work part time, and you should add to that the number who are discouraged who are looking for jobs but who have given up and who might have, perhaps in June or July of this year,

with all of this esoteric talk of recovery, said: "Well, look, jobs are available and I'm going to start looking for a job," and now you're beginning to count them? In other words, don't we have a human problem that, despite all of this theorizing and the use of statistics on both sides—one to be pessimistic and one to be optimistic—but the fact remains that we have a large number of individuals who are unemployed and who possibly, if there is a misery index, should be counted, many more than we are willing to admit or to recognize? And what would you say that number would be if you add in these other individuals and come to a true level of how many persons are really unemployed? Approximately how many would you estimate?

Ms. NORWOOD. Well, Congressman Hawkins, let me just say first that I agree with you completely that we need to look behind these numbers. What I have been trying to do today is to explain that we cannot focus on a single month.

Representative HAWKINS. We all agree.

Ms. NORWOOD. My job is to stay in between, by the way, those who wish to use the numbers in one way or those who wish to use the numbers in another way. We do have an extraordinary number of people who are working, more than 105 million. We also, as you point out quite rightly, have some 8.5 million unemployed. We have another 5.3 million people who are employed but who are working part time because they cannot find any other job, and we have, as of the end of the second quarter of this year, another 1.3 million who have told us in the household survey that they are not looking for jobs because they believe no job is available.

Representative HAWKINS. Would you agree with my mathematics as you read these off, if we counted the 8 million, if we counted the 1 million who are in effect discouraged workers and indicated in your survey that they wanted a job, and if we counted one-half of the 5.3 million—let's just count 2 million of them—we would arrive at an 11 million count—or let's say between 11 and 12 million. Is that about accurate?

Ms. NORWOOD. Yes.

Representative HAWKINS. So that instead of talking about 8 million unemployed people, we are really talking about between 11 and 12 million, which is a very tragic situation, to have that many persons unemployed and then talk about recovery. I notice in the bulletin which was issued by your department last month, you led off by saying that 2.7 million fewer persons experienced unemployment in 1983 than in 1982. Now that sounds like a very remarkable recovery, a very remarkable statement, and I can understand why the Congress fails to pass a jobs bill because it sounds like everything is good. But then you use 1982 as a point from which you measure that so-called recovery and in that year—1981—we certainly didn't have anything to boast about, but those suffering from unemployment were 26.5 million that year. So we had a deep depression.

So doesn't it depend on what year you're measuring from when you say that 2.7 million fewer persons experienced unemployment in 1983. Certainly we have more persons employed today than in 1982, but that was a year of depression. Is that a good index as to whether or not we are making progress, whether or not we are

moving toward the goals of achieving reasonable full employment in this Nation? Doesn't that suggest that there probably—instead of trying to engage in projections or merely guessing at what the future is going to be, that we should be constructing programs to make sure the future is going to be what we want it to be and not trying to guess what it's going to be next year or measuring this year's performance against a recession year. It just seems to me that for policymaking that we are using statistics in the wrong way. We are relying on them to try to prove a case when we're not doing anything to even change them to make them look better.

Am I suggesting a policy decision on your part?

Ms. NORWOOD. Well, Mr. Hawkins, let me just say that that release that you referred to did point out that almost 24 million people in 1983 experienced some spell of unemployment during the year and that among blacks with some job-seeking activity about one-third of them reported that they had no job at all during 1983.

You are quite right that people look at the numbers and pick out whatever it is they are interested in. Our job, however, is to present these data in as comprehensive a form as possible so that all of you who are making the policy in the Congress will have the information that you need. We do have a constantly increasing population and an increasing labor force and we need to keep moving forward in the creation of jobs in order to keep up with the numbers of people who want and need jobs.

We sometimes, I think, fall into some difficulties because we tend to look at the unemployment rate as a measure of hardship and it is not. It is a measure of the number of people who are without jobs and are looking for them. It is more like a measure of labor supply perhaps than hardship. There are many people—the long-term unemployed, for example, who are in very serious difficulty and we have a considerable number of them, although that number has been declining during the recovery. We also have among the unemployed many people who want jobs and who perhaps need jobs, but who are not in very great financial distress. And, as you well know, we have many people who are working full time at wages that are extraordinarily low, and even though they are not counted among the unemployed, they are indeed in some financial distress.

So I think we need to look at all of the data and we need to look at what's behind it all in order to determine where the policymakers need to make changes.

Representative HAWKINS. Thank you, Ms. Norwood.

Thank you, Mr. Chairman.

Senator JEPSEN. Thank you, Congressman.

Today's figures have been repeated time and time again this morning about the approximately 8.5 million unemployed, slightly above the 1981 figure of 8.5 million, somewhere in that area, but just setting those aside for a minute to get at an accurate picture of how we are really doing by comparison to where we have been and how we've done in the past, wouldn't the question be more appropriate if we said we know that the number of Americans holding jobs today is very close to its historical record level, and then ask, how does the proportion of Americans holding jobs today compare to the historical levels? Because that does take into account that

our Nation's population has grown and I think that would be the most accurate way to look at this.

So how does the proportion of Americans holding jobs today compare to the historical record?

Ms. NORWOOD. The employment-population ratio, which is the proportion of the population of working age with jobs, for July was 59.7, slightly lower than June, and at about the level of May. That is very high by historical standards. The record high of 60.1 percent occurred in several months of 1979, so 59.7 is very high.

Senator JEPSEN. It's at or near the historical high?

Ms. NORWOOD. Yes.

Senator JEPSEN. So that includes all the factors we were talking about, behind the scenes, in front of the scene, and around them? It's important progress.

Ms. NORWOOD. It's an aggregate number.

Senator JEPSEN. At or near a historic high.

Ms. NORWOOD. Yes.

Senator JEPSEN. Last month's long-term interest rates dropped significantly. That's good news. And I have some figures on civilian employment patterns during the previous postwar recoveries that I'd like to ask the Bureau to verify for the written record.

Ms. NORWOOD. Very well.

Senator JEPSEN. I will move along rather quickly. According to my figures, employment rose from a low of 57.1 million in June 1949 to a high of 62 million in March 1953. Yet before employment finally did reach its peak, there were 18 occasions in which the Bureau monthly reported employment levels appeared to decline.

Ms. NORWOOD. I can't do that very rapidly. I'm sure that with your competent staff, Senator Jepsen, that the numbers must be correct, but we will verify them for the record.

[The following information was subsequently supplied for the record:]

There were 17 employment declines from October 1949, the start of the recovery period, and 18 if we start from June 1949.

Senator JEPSEN. We'll go on. I would appreciate that. We'll go on and I'll do this rather quickly. During the expansion that began in 1954, monthly employment levels appeared to decline on 10 occasions before employment reached its peak. During the expansion that began in 1958, monthly downticks in employment levels were reported on 10 occasions. During the long expansion that began in 1961, monthly employment figures appeared to decline on 29 occasions before the employment peak was finally reached.

During the expansion that began in 1971, the employment level estimated on a monthly basis appeared to decline on five occasions before reaching a peak. During the expansion that began in 1975, monthly employment levels appeared to decline on seven occasions before employment reached its peak.

So, Ms. Norwood, for the benefit of the committee and the American public, if you can verify these things, we will put them in the record and you can tell us whether temporary declines in employment levels are usual features of U.S. business cycle expansions. If these facts are true, you could make the statement now.

Ms. NORWOOD. Of business cycle expansions, no.

Senator JEPSEN. In other words, temporary declines in employment levels are a usual feature of U.S. business cycle expansions?

Ms. NORWOOD. I'm sorry. Temporary, occasionally. There are ups, and downs, of course.

Senator JEPSEN. Up to 29 on an occasion and 10 on another?

Ms. NORWOOD. Yes.

Senator JEPSEN. Very typical.

[The following information was subsequently supplied for the record:]

From May 1954 to the employment peak in September 1956, employment declined 10 times.
From April 1958 to September 1959, employment declined 10 times.
From February 1961 to April 1970, employment declined 30 times.
From November 1970 to July 1974, employment declined 6 times.
From March 1975 to February 1980, employment declined 7 times.

Senator JEPSEN. Now then, more to the present. Ms. Norwood, yesterday the Joint Economic Committee held hearings on the mid-year economic outlook. Donald Ratajczak of Georgia State University forecasted an unemployment rate of 6.5 to 6.6 percent by the end of the year. Mr. Michael Evans, president of Evans Economic forecast a rate of 6 to 6.2 percent. Mr. Ratajczak cautioned us that we could expect to see one or two upticks before the end of the year.

Are the unemployment figures you reported this morning necessarily inconsistent with these positive forecasts made by these two economists yesterday?

Ms. NORWOOD. We have some 5 months more to the year and almost anything could happen. No, I don't think they are. They are certainly basing their information on a much longer term than a single month. Clearly, if the most recent changes were to continue, their estimates would be off. But, as we have indicated today, we really need to see a couple months more before we can tell.

Senator JEPSEN. Senator Proxmire.

Senator PROXMIRE. Commissioner Norwood, the number of unemployed who lost their jobs, the job losers, rose in July after months of steady decline. Why did that happen?

Ms. NORWOOD. Because we had a decline in seasonally adjusted employment and I think we are just seeing the consistent change in unemployment.

Senator PROXMIRE. But sometimes that decline in employment comes because more people come into the work force and so forth, particularly in the summer months. But in this case, there were more job losers.

Ms. NORWOOD. Yes, that's correct.

Senator PROXMIRE. And I wonder if you have any explanation for that.

Ms. NORWOOD. No, sir.

Senator PROXMIRE. Now the Census Bureau reported this week that the poverty rate rose in 1983 to 15.2 percent. It was the fifth increase in a row, the highest rate since 1965. The number of people living in poverty increased to 35.3 million, 900,000 more than in 1982.

I want to ask you a couple questions about that. No. 1, are the adults in these families structurally unemployed?

Ms. NORWOOD. I'm not sure. I haven't looked at all of the poverty data, but certainly we will find a very large group of them in any case are women maintaining families. Many have very few skills. They are certainly what we would call structurally unemployed. Many minority males would certainly be among that group. Yes, I think that a large proportion at least of those have very low very little, and most of them are not working at all and over long periods of time. They are among our long-term employed.

Senator PROXMIRE. Do the rising poverty rates correspond to increased dependency on welfare?

Ms. NORWOOD. I don't know.

Senator PROXMIRE. It doesn't seem logical that it would?

Ms. NORWOOD. I just can't respond to that.

Senator PROXMIRE. Now we have a chart here on the so-called misery factor which I think is a fairly simple factor. What you do is you simply add the inflation rate to the unemployment rate. That might be an easy concept to sell snake oil on, but I just wonder how true it is. It seems to me the real misery factory is the poverty index because they are the people who feel misery deeply because of the downtake or downdrop in the economic activity. The recovery certainly through much of 1983 did not improve that intense measure of misery; that is, the number of people in poverty.

Can you give us any help in interpreting how much the recovery through July 1984 has been in reducing people living in poverty? Undoutedly, it's improved some over what it was last year, but it's likely still to be, in my judgment, quite high. Is that right?

Ms. NORWOOD. I would expect so. I have only seen the Census Bureau release just a little while ago and I'm not familiar with all of its details, but we do know that we have roughly 1.6 million people who, according to our labor force figures, have been unemployed for 6 months or more. These people would tend to be more likely than the short term, at least unemployed, to be included in poverty figures and they have not benefited from the recovery. On the other hand, there are many people who had some unemployment during the recession, but were able to find jobs during the recovery.

Senator PROXMIRE. So you're telling us it is not inconsistent or inconceivable that you might have a situation where although employment is recovering and unemployment may be falling, you still may have an increase of people in poverty.

Ms. NORWOOD. Well, we don't——

Senator PROXMIRE. As I say, it was higher last year in 1983, a full year of recovery. After all, the year didn't start until 6 months after the recovery went into effect. The number of people living in poverty was higher than it had been since 1965, nearly 20 years.

Ms. NORWOOD. There is not necessarily a strong correlation between the unemployment status of an individual and his financial situation. Many people who are unemployed receive unemployment insurance benefits. Many unemployed people live in families where there are other workers who bring in some income. Many people are working at very low wages and are in poverty even though they are working. Others in poverty have no labor market participation at all. So we really have to look very carefully I think at the family income situation.

The unemployment data, the labor force data, are based upon a person concept, not on a family concept, and all the poverty data are based upon family income.

Senator PROXMIRE. So that an individual could be working or many individuals could be working and working at low wages and still be in poverty?

Ms. NORWOOD. Possibly.

Senator PROXMIRE. For example, in July there were 5.3 million people working part time involuntarily. They wanted full-time work but they couldn't get it. All they could get is part-time work. So with quite strong growth of employment during recovery, a lot of people who want to work full time can only get part-time jobs. Why is that, despite the recovery?

Ms. NORWOOD. I think it's partly based upon the skills of the individuals and their location. We have pockets—as we always have had in this country—of high unemployment and pockets where there is great prosperity. We had a very deep, very steep, and very long recession, and in some cases there remains geographic difficulty. People in this country tend not to move very rapidly or very readily in search of jobs. So you have that kind of problem. But you also have the problem that the industrial composition of the country is changing, the occupational mix is changing, and the skill needs are changing, and we have to keep up with that.

Senator PROXMIRE. Now I notice that one of the most startling figures I have seen recently appeared in the paper just a couple of days ago. It said that for the first time in the history of this country, white males constitute less than one-half of the work force. Commissioner Ehrenhalt, with whom you're undoubtedly familiar, who's the head of labor statistics for the New York region I believe——

Ms. NORWOOD. Yes, sir.

Senator PROXMIRE [continuing]. Says that of the 10 occupations that will hire more workers than any other in the next decade, 8 of those 10 are predominantly female occupations. Between 1982 and 1995, he also figures women will account for 64.5 percent of all new workers. In other words, two-thirds of the new workers will be women.

Now one other figure—and I'd like you to comment—between July 1981 and November 1982—that was the recession period—employment declined by 1.7 million. Men age 45 to 64—that is, the older men in the working force—lost 520,000 jobs, half a million jobs. Between November 1982 and June 1984, jobs increased by 6.7 million, four times as big or four or five times as big an increase as the number of jobs that were lost, but men age 45 to 64 got only 207,000 jobs, only about 40 percent of those who lost their jobs were able to get jobs during the recovery.

What are the implications of that for the future? Does that suggest that we are likely to have more unemployed men? The figure for the first time recently showed that they had a lower unemployment figure for women than for men, doesn't this suggest—Mr. Ehrenhalt's figure, your colleague in the department—doesn't it suggest that we're going to have a continued problem, more of a problem with male unemployment than female unemployment?

Ms. NORWOOD. Not necessarily. What Mr. Ehrenhalt was talking about were the Bureau of Labor Statistics projections to 1995 that were issued some months ago and Mr. Kutscher, who is our Associate Commissioner for that program, has testified about those data on several occasions before the Congress here in Washington.

We do see a long-term decline has been occurring in the labor force participation of men, particularly older men. This accelerates in any period when there is a recession or economic difficulty. The older men who lose their jobs tend to go into retirement rather than coming back into the work force. The population, as we all know, is getting older and we've had fewer people born, and the whole labor force is going to be in a sense aging.

Senator PROXMIRE. But only a tiny percentage of the 45 to 64 age group can retire without being eligible for any social security. At 62 you can retire and get 70 percent of your social security benefits, but if you retire at 61 you get nothing. So it would seem to me that there wouldn't be many retiring voluntarily. Most of those people between 45 and 64 are unemployed.

Ms. NORWOOD. Many of them—not all of them, but some of them at least have gone into voluntary retirement with some arrangements with the companies in order not to rehire them to smooth over the economy. I don't know how many of them, but I think that the other point is that we do expect more women to come into the labor force. Women's growth in labor force participation slowed down during the recession. It is picking up now and probably will continue to pick up some in the years to come.

I have a little trouble with the view that jobs that will be increasing are female jobs or male jobs. I think we have come to the point in this country where we are looking at jobs as jobs that all people will have access to. We do know that in some parts of the goods-producing sector there has been long-term structural decline.

Senator PROXMIRE. Let me just interrupt to say I agree with that and I think you're absolutely correct and I think all of us would like to see abolition of that gender-related job situation, but it's a fact of life. The fact is that most of the secretarial jobs will be filled by women probably in the next 10 or 15 years, maybe not certainly but probably. Most of the jobs for nurses will be filled by women. Many men are getting into that profession more than ever before and women are getting into male professions, but we can expect that there will be some continued concentration. Most of the jobs for nurses and for secretaries will be filled by women. Isn't that correct?

Ms. NORWOOD. Probably, yes. About 97 percent of them now are filled by women. My point is that what we are seeing ahead is—and what we have been having in the last year or more of recovery—is a considerable expansion in jobs in the service-producing sector and I think most people look at those and say, well, they are the secretarial and nursing and other low-paying jobs, that are usually filled by women. But there are also rather high-paying jobs with sophisticated training, much of which are also being filled by women.

So I think we need to look a little bit more carefully at the specifics of the data in looking at that whole question of where we are going to be in the future.

Senator PROXMIRE. One more question. This is a question that relates to funding for your agency and so it's very important to you and it's very important to us, too, because we rely so heavily on you for information that's so important for policy the Congress should follow.

The House passed an appropriations bill that includes an additional $6.5 million for BLS to develop new data on mass layoffs and plant closings. What kinds of information would BLS be able to provide if this appropriation goes through? In particular, will there be more information about what happens to unemployed people over time, do they find jobs, do they exhaust unemployment insurance, go on welfare, and so forth. Will that be more available to us?

Ms. NORWOOD. Yes; it would. Let me just say, Senator, that the Senate has also included something additional in our budget that was not in the President's budget, and that is about $1.5 million for work to improve price, productivity, employment, and wage data on the services sector. The House committee added a program for developing what is called mass layoff data.

I think the important thing to know about that is that the Congress requested that the Bureau develop a possible approach to a program of this sort using the unemployment insurance records to try to trace people through their periods of unemployment and then after they've dropped out of the UI system survey to find out what has actually happened to those people who have been unemployed for long periods of time. It's a difficult thing to do. It is not part of the President's budget and I'm sure you understand that I support the President's budget with its economy.

Senator PROXMIRE. Thank you.

Senator JEPSEN. Congressman Hawkins.

Representative HAWKINS. I have no further questions. Thank you.

Senator JEPSEN. Ms. Norwood, do weekly hours and overtime remain in what you consider a relatively high level?

Ms. NORWOOD. Yes, sir. They are extremely high by any measure.

Senator JEPSEN. And on the basis of just practical experience for those of us who have met payrolls prior to coming to the Congress and hired people, is this an indication that additional employment gains are to come?

Ms. NORWOOD. We have had considerable payroll growth this month, particularly in industries like machinery electrical equipment, and fabricated metals where we need to have that growth. That has come this month.

Senator JEPSEN. The point I was making is in the real world of business when you have weekly hours that are kept high and you have considerable overtime and so on, you do this for a certain period of time—the businessowner does this in meeting the payroll until they are sure as they project out here that whoever they do hire, they hire and they can keep them on the payroll and they really need them, in other words. So what I'm saying is the fact that the weekly hours are high, the overtime is relatively high, would indicate that it bodes well for future hirers.

Ms. NORWOOD. That's possible.

Senator JEPSEN. Commissioner, the dramatic decline in inflation that we have witnessed under the current administration is important because of the benefits it produces for the typical American worker and consumer. I understand that the Consumer Price Index for urban wage and clerical workers increased by 3 percent during the year ending in June.

Did the increase in average weekly earnings over this year keep pace with these modest price increases?

Ms. NORWOOD. Yes; it didn't increase that much. But what was the second part?

Senator JEPSEN. Did the average increase in weekly earnings keep pace with these modest price increases?

Ms. NORWOOD. Yes; real earnings are up.

Senator JEPSEN. How much are real average weekly earnings up?

Ms. NORWOOD. I will have to supply that for the record. I don't have the specific figure here. But they are up.

[The following information was subsequently supplied for the record:]

Real average weekly earnings increased by 2.0 percent over the year ending in June 1984.

Senator JEPSEN. If you would, I would appreciate that. More specifically, I understand that the most recent month for which you have unemployment data for all States, that May is the most recent month that you have that?

Ms. NORWOOD. Yes.

Senator JEPSEN. What was the civilian unemployment rate in Iowa in May of this year?

Mr. PLEWES. Senator, we report 8.1 percent.

Senator JEPSEN. In May of this year?

Mr. PLEWES. I'm sorry. I will supply that for the record.

Ms. NORWOOD. It's considerably lower than that. That was an earlier number. We don't have that number with us, but we will supply it for the record.

Senator JEPSEN. In May of 1983, what was it?

Mr. PLEWES. That was it.

Ms. NORWOOD. That was the 8.1 percent. It's considerably lower now.

Senator JEPSEN. That's correct. It's 6.8 percent now.

Ms. NORWOOD. I'm sorry. We try to come prepared, Senator, but sometimes we slip up.

Senator JEPSEN. How many States experienced an improvement in their unemployment rates over this year?

Ms. NORWOOD. We can supply that for the record, but it's quite a large number, a very large number.

[The following information was subsequently supplied for the record:]

All States experience a drop in their rate of unemployment from May 1983 to May 1984, although a few of the declines were as small as two- or three-tenths of a percentage point.

Senator JEPSEN. Finally, all I have to say in reply to my distinguished colleague, Senator Proxmire, when he was talking about the misery index and referring to it as a kind of snake oil thing, it was a snake oil thing that was invented as an artful figure of

speech by the late Arthur Okum who was an adviser to the Democrat President Johnson and also an adviser to Democrat President Carter. He held a position as senior fellow at Brookings Institute in 1970 until his death in 1980. So if he wants the formula for snake oil, he might ask some of his fellow Democrats what that formula is because they invented it,

I have no further comments or questions. Do you have anything that you like to say in closing?

Ms. NORWOOD. No, sir.

Senator JEPSEN. I again thank you, Ms. Norwood. You are the most consistent credible witness—and that isn't meant to be any reflection on any Cabinet members or anybody else—but you have been consistent over the years, year in and year out. I have sat here for about 5½ years, through both a Democratically controlled Joint Economic Committee and now as the first Republican since Bob Taft to chair this committee, and on all occasions, on every meeting—sometimes in tough political situations—you have remained consistent and without fear or favor. I find your answers very refreshing and I thank you for that and commend you for it.

Ms. NORWOOD. Thank you very much.

Senator JEPSEN. The committee is adjourned.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

THE 1984 MIDYEAR ECONOMIC OUTLOOK

WEDNESDAY, AUGUST 8, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD-G50, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen and Symms; and Representatives Hamilton, Scheuer, and Snowe.

Also present: Dan C. Roberts, executive director; James K. Galbraith, deputy director; Charles H. Bradford, assistant director; and Edward Abrahams, William R. Buechner, Robert R. Davis, Mary E. Eccles, Christopher J. Frenze, and Dale Jahr, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Good morning, Mr. Secretary. It's a privilege to have you appear before the Joint Economic Committee and we look forward as always to your testimony this morning.

Our country is in the midst of one of the strongest, most sustained periods of economic growth ever experienced. We have had a stream of good economic news for 19 straight months, and it's likely to continue. In fact, it's predicted to continue well into the future. Indeed, it must continue if all parts of the economy, especially agriculture, are to receive their just rewards.

The first six quarters of the recovery have registered the strongest economic growth and recovery since the Korean war. Growth in business spending for plant and equipment during this same period has about doubled that in the previous recoveries.

The most important gains have been in the measures that affect us all—employment and inflation. Consumer prices in the United States are rising about one-fourth of the 1980 rate and there's no sign that inflation is heating up. Contrary to public opinion, we can have rapid economic growth and low inflation at the same time.

On the employment front, the U.S. economy has created 6.4 million jobs since the recession ended in November of 1982. Now that's the best job creation for a 20-month period in the U.S. history. I would additionally point out that these are real jobs, not tax provided government jobs.

Our growth policies have caused us to far outperform the employment situation in Europe. The 19 European OECD countries have seen a 2.5 decline in employment since the end of 1982. It's unfortunate, and I wish it were otherwise. While everyone had

some idea that the U.S. economy was improving early in 1983, most underestimated the impact of the fiscal reform. The strength of the recovery has surprised all except the most optimistic of observers. You and I have been pretty much consistently among those optimists, Mr. Secretary.

The administration's policy leadership had helped to create a strong economic expansion.

Secretary Regan, we would appreciate your views on the future course of economic events and the policies that are needed to ensure strong yet sustainable expansion. I would at this time yield to the very distinguished vice chairman of this committee, Congressman Hamilton, for any remarks he may have.

Representative HAMILTON. Thank you very much, Mr. Chairman. We're delighted to have you, Mr. Secretary. We look forward to your comments.

Senator JEPSEN. Is there anyone else?

OPENING STATEMENT OF SENATOR SYMMS

Senator SYMMS. Thank you, Mr. Chairman. I share your point of view in your opening statement. I thank you for it. The question that I would like to have answered here is whether or not the Secretary thinks that tax increases are inevitable next year, as Walter Mondale seems to parade around the country and say that they are. And I'd like to have the Secretary of the Treasury, who I assume is intending to continue on as Secretary of the Treasury—and I hope he is next year—what his plans are specifically, if any, in terms of how to handle the budget deficit because, in my judgment, tax increases are not inevitable but moderate spending reductions would take care of the problem. But I'd like to hear that and I hope he will address that in his comments.

Senator JEPSEN. Congressman Scheuer.

OPENING STATEMENT OF REPRESENTATIVE SCHEUER

Representative SCHEUER. Thank you, Mr. Chairman.

It's a pleasure to welcome you back, Mr. Secretary. It has always been a pleasure to have you here, first because of your high professionalism and forthright and foursquare manner of dealing with us, very professional and very open; and second because of your unfailing good humor. This morning will not be the morning to end your unfailing good humor because the economy is booming and we only have one America, the people in this panel; and only have one President; and we all take satisfaction in the fact that America is heading toward prosperity with very clear signals, and nobody is trying to denigrate the remarkable progress our economy has made.

We do have some questions for you in the full passage of time here this morning and we will look forward to your testimony and some questions after that.

Senator JEPSEN. Mr. Secretary, in my nearly 2 years as chairman of this Joint Economic Committee, I don't recall a witness receiving such a warm and genuine welcome, and it's great testimony to you. It also makes me wonder what's coming later on in this hearing. You may proceed.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I thank you for your kind words. I do welcome this opportunity to meet with you to discuss the state of the economy at midyear and the outlook for the future.

REVISION TO OUR OFFICIAL FORECAST

We have made no basic change to the forecast path for the economy in the midsession budget review, but we have updated the figures for stronger than expected first half performance.

The more rapid growth and lower inflation during the first half of this year had led to a markup of real GNP growth for the entire year 1984 and also markdown of inflation. For the years beyond 1984, the pattern of real growth and inflation is virtually unchanged from prior forecasts. Table 1 of my prepared statement summarizes the differences between the January budget, the April update, and the midsession projections for 1984.

Table 2 of my prepared statement shows key aspects of the midsession economic projections out of 1989. The dramatic improvement in unemployment has led to a markdown of projections of the unemployment rate over the next several years. On the other hand, the forecast of interest rates has been pushed up a little.

In the second half, growth is projected to slow down from the first half of 1984's pace to a 4 to 4.5 percent annual rate. Even so, 1984 will follow in the 1983 pattern as one of the strongest years for real growth in the postwar period.

ACCURACY OF LONGER TERM FORECASTS

In the past, longer term forecasts have been far wide of the mark, and for that reason as well as because of changes in laws and policies regarding revenues and outlays, longer term budget estimates have also been badly in error. Of course, changes in economic conditions can have a sizable impact on the Federal budget. CBO estimates that over a 5-year period a 1-percent increase in real growth would trim the fifth year deficit of their baseline budget by $105. billion. A 1-percentage point increase in interest rates over 5 years would add $26 billion to the fifth year deficit.

Policy changes can also make a difference. I think it's either terribly cynical or terribly mechanical to assume that government would choose to remain totally unresponsive to changing economic conditions and that any 5-year budget forecast will remain unaffected by policy decisions.

All of the foregoing imply that both the longer-term economic assumptions and the budget projections on which they are based should be viewed with much skepticism. Congress may want to reconsider the requirement of the 5-year economic forecast and budget outlook.

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BUDGETARY RESULTS AND THE LONGER TERM FISCAL OUTLOOK

The midsession review of the budget will be out in a day or so. The attached charts that I will be adding as part of my written prepared statement, except where noted, are based on the April update numbers which are not dramatically different.

I hope that we will hear no more talk of $200 billion deficits as far as the eye can see. Our deficits have been helped substantially by the downpayment package. Currently, the deficit is estimated at just under $175 billion in 1984 and is expected to decline below that in 1985 and the outyears. With the rest of the downpayment and our budget proposals, the budget deficit is expected to fall from just under 5 percent of GNP in 1984 to between 2.5 percent and 3 percent of GNP in 1989.

State and local surpluses are expected to run between 1 percent and 1.5 percent of GNP for the next several years. These surpluses will offset much of the 1988 and 1989 Federal deficits and total Government borrowing will not have a significant net impact on the credit markets at that time. That's chart 4 in my prepared statement.

It's important not to underestimate the favorable budget impact of the downpayment package. Over the 1987-89 period, the national debt will just be keeping pace with the growing GNP. With only slightly more restraint on the growth of spending, the debt will begin falling again relative to GNP and debt service will begin falling again relative to tax revenue and other budget outlays. That's chart 5, Mr. Chairman, in my prepared statement. As you can see, here it is on this line under the projections of: "A" current services, nothing being done; "B," the green line, debt rising at the same rate as we project for gross national product; "O," debt rising at tha same rate as inflation.—that's going down; and finally, "D," the 1985 budget projections. So any one the these paths is possible in those years.

A debt falling relative to GNP would free up increasing amounts of normal year-to-year revenue growth for deficit reduction and for funding other Government outlays. Thus. the downpayment reduces the remaining budget problems to levels which can be handled by reasonable spending restraints on the part of Congress. It does so without repeal of the tax rate reductions and incentives for growth which are also critical to the deficit reduction effort. Growth is the key to the deficit problem. There can be no solution without growth. With growth, the solution is well within reach.

The future budgetary problem does not arise because the American people are undertaxed. And I have here, Mr. Chairman, as chart 6 in my prepared statement what outlays and receipts are as a percent of GNP. Under existing law, Federal tax receipts will be between 19.4 percent and 19.7 percent of GNP over most of the 1985-89 period. That's right in here, Mr. Chairman, practically approaching to 20 percent area, and as you can see, this is more or less the historical path of where we have been on receipts.

But this out here [indicating] is nearly a percentage point more than what was considered normal during this period here in the 1970's. Outlays are even further above their historical levels. Outlays are the part here in red. They will still be above 22 percent of

GNP by 1989 without further restraint on the growth of spending or faster than projected economic growth.

You can see where it is, Mr. Chairman. Even bringing it down, it still remains at 22 percent, well above the historical highs for outlays as a percent of our gross national product.

In fact, if budget outlays could grow slightly more slowly, perhaps about half as fast in real terms as real GNP, the budget would be well on the way to being balanced by 1989. In other words, what I'm suggesting, Mr. Chairman, is if there's slightly less spending, bringing it down in here brings us down almost to balance.

It matters very much how we close that remaining budget gap. Tax increases and spending cuts are not interchangeable alternatives for deficit reduction. Tax increases worsen the economic outlook and make budget balance that much harder to achieve. Spending reductions free up resources for faster growth and reduce the task of making ends meet.

It is sometimes argued by advocates of big government that the Reagan tax cuts were too large. In fact, the tax cuts were barley large enough to offset ongoing tax increases. Over the period from fiscal year 1981 through fiscal year 1989, the 1981 Economic Recovery Tax Act, ERTA, cut taxes by a cumulative amount of nearly $1.490 trillion, but there already have been a long list of tax increases.

Mr. Chairman, if you take a look at this table, which is table 3 in my prepared statement, you will see here the 1981 tax cuts which everyone said were too long—well, a lot of people said were too large. Now since that time, we have been getting tax increases: $650 billion in inflation induced bracket creep which, fortunately, will end with the introduction of tax indexing on January 1, 1985—that's this figure here [indicating]; nearly $290 billion by the 1977 Social Security tax rate increases that were mandated; about $310 billion from the Tax Act of 1982, TEFRA; $128 billion from the gasoline tax increase and the 1983 Social Security amendments and from other miscellaneous tax increases—that's this figure here [indicating]; and $100 billion from the downpayment package which we've just enacted.

In case somebody says, "Well, wait a minute, I thought that down payment figure was only supposed to be about $50 billion," we have extended that out to 1989. That $50 billion tax figure in the downpayment is for a 3-year period. This figure of $100 billion, is for the 5-year period from 1985 to 1989.

These tax increases total more than a staggering $1.475 trillion, leaving a net tax cut of just over $12 billion, or a 9-year average net tax cut of about $1.4 billion.

The American taxpayer might legitimately ask, "Where's the beef?" It's not there.

For a typical family earning about $25,000 in 1982, the Reagan tax cuts have roughly offset ongoing tax increases from inflation induced bracket creep and payroll tax increases. That's chart 7, Mr. Chairman. Now, without the tax cuts, the Federal tax burden would have soared to over 21 percent of income in 1988. That's extending the 1980 law forward.

However, we have the tax cuts here in 1981, the black line, which have brought them down. Instead, the family's tax burden will remain at between the 1980 and 1981 level or roughly 17 percent of income. There will still be a slow rise in the tax rate due to the payroll tax increases in 1985, 1986, 1988, and again in 1990. These are all payroll taxes for Social Security and the like.

Repeal of indexing would send the family's tax burden soaring, as under prior law, by about $350 by 1988 and more than $550 by 1990. That's this green line here, Mr. Chairman, showing what the effect would be of repealing indexing on a family of four with an income of $25,000 in 1982 with cost of living adjustments.

In fact, if the family experiences real wage growth, it will still face bracket creep and a rising tax rate. That's an important point. Prior to indexing, the Government could profit from inflation. Federal tax revenues and spending could grow in real terms as inflation raised tax rates, even if inflation reduced GNP and raised unemployment. But with indexing, Government cannot profit from inflation. Government gains revenue only from real growth, real wage increases and reduced unemployment.

Budget balance now depends on cutting spending and promoting real economic growth, not on inflation, tax increases and rising unemployment.

The consensus outlook is calling for about a 5-percent rate of inflation for the second half of 1984. The administration has a similar forecast. But it's important to recognize there is a possibility that, once again, inflation could come in much lower than projected. For example, the Producer Price Index has registered 3 successive months of no change. Industrial commodity prices were rising earlier in the expansion but have been very soft in recent months. Spot oil prices are generally below contract prices and are down from 2 years ago.

Disinflation is showing up in lower farmland values and commodity prices. They are up from a year earlier, but are leveling off now in response to the prospects of larger harvests this fall. Upward wage pressures have been reduced greatly even though real wages are rising. In 1979, 1980, and 1981, growth in nominal compensation ranged from 8.8 percent to 10.7 percent, yet prices rose even faster. Real compensation declined, especially on an after-tax basis as inflation raised tax rates.

In 1982, 1983 and the first half of 1984, nominal compensation slowed substantially, yet still outstripped price increases, especially on an annual after-tax basis.

The financial markets often seem to have reacted adversely to reports of strong real growth even in the absence of inflationary pressures. The idea that the economy is on the verge of overheating and the fiscal and monetary brakes need to be applied is at variance with the facts. It would be more in accord with reality to recognize that unemployment is still too high and too much of the Nation's plant and equipment stands idle.

The current expansion is still in its early stages and has some considerable distance to go before relatively full utilization of resources is reached.

MONETARY POLICY AND THE FEDERAL RESERVE

The Fed's current wariness about the threat of a future outbreak of inflation is understandable, even in the context of the very small price increases of recent months. Inflation has been a stubborn and a difficult problem. It would be a serious policy error to squander the progress we have made by reverting to an inflationary monetary policy, but it is also important that the Fed not overdo a policy of restraint. An overly stringent monetary policy would end up fighting, not price inflation, but real growth.

We feel the Fed should monitor the situation carefully and provide sufficient money and credit to sustain economic growth without rekindling inflation.

INTEREST RATES AND FINANCIAL MARKETS

A major immediate concern to the U.S. monetary authorities must be the level of interest rates. We want them to come down. We felt for some time that there was ample room for them to fall and that economic environment in the months ahead would allow then to do it.

In May, both short- and long-term interest rates were substantially above current inflation rates and, in my view, above inflation rates that are likely to occur in the foreseeable future. Real rates of interest, both short and long, seemed high by historical standards.

Since May, long bond rates have fallen substantially. I hope these favorable interest rate declines reflect a belated acknowledgement by the market that inflation is down and an increased confidence that inflation is down to stay. The recent strong rallies in the stock and bond markets and the resulting lower long-term interest rates are long awaited moves in the right direction. I hope that this improvement in confidence in the long end of the market will soon be matched by a fall in interest rates in the short end of the market.

Near-term, inflation is certainly low and uncertainty over the short run should be even less than uncertainty over the long run.

In concluding, Mr. Chairman, at midyear, the economy is growing strongly and inflation is subdued, if not in full retreat. Noninflationary growth is the goal of our program and the best means of closing the budget gap.

To hasten that process, Washington should work harder on spending less, holding the line on taxes, and removing the regulatory straitjacket from American business. That's what American taxpayers want. That's what they deserve.

Thank you, Mr. Chairman.

[The prepared statement of Secretary Regan follows:]

PREPARED STATEMENT OF HON. DONALD T. REGAN

Mr. Chairman and Members of the Committee:

I welcome the opportunity to meet with you today to discuss the state of the economy at midyear and the outlook for the future.

Revisions to the Official Forecast

We have made no basic change to the forecast path for the economy in the Mid-Session Budget Review, but we have updated the figures for stronger than expected first-half performance.

- Real growth picked up to about an 8.75 percent annual rate in the first half of this year and has averaged a 7.1 percent annual rate during the six quarters of the current expansion. Real growth has been well above the 5.9 percent annual rate averaged in comparable spans of previous expansions, with the sole exception of the Korean War period.

- The civilian unemployment rate has declined during the current expansion by 3.2 percentage points to 7.5 percent in July. Civilian employment has increased by 6.4 million persons since the end of 1982 -- a record advance.

- In spite of continued high interest rates, and contrary to frequent misstatements by the media and some financial analysts, this is an investment-led recovery (Chart 3), not a consumer-led recovery. Business fixed investment has risen at a 16.3 percent annual rate in the last six quarters, compared with 7.3 percent averaged in earlier cyclical expansions.

- Far from leading the recovery, consumer spending ran slightly behind previous experience during the first year of the expansion. With strong growth in the first half of this year, consumer spending has now pushed a little ahead of gains in prior expansions as shown in the chart.

Because of the improved economic performance, the levels of the economic variables, although not their general trends, have been adjusted in the outyears. The magnitude of the shifts in the current levels of the economic statistics from initial estimates during the first half of 1984 illustrates the uncertainty of economic forecasting. It certainly calls into question the making of five-year projections. Congress may want to reconsider the requirement of a five-year economic forecast and budget outlook.

The more rapid growth and lower inflation during the first half of this year has led to a markup of real GNP growth for the entire year 1984 and also a markdown of inflation. We now expect real GNP to rise by 6.5 percent during the four quarters of 1984. The 6.5 percent figure has been marked up from 5.0 percent in April and 4.5 percent in the January budget. Inflation as measured by the GNP deflator is anticipated to increase 4.4 percent over the course of this year, down from estimates closer to 5 percent in January and April. For years beyond 1984, the pattern of real growth and inflation is virtually unchanged from prior forecasts. Table 1 summarizes the differences between the January Budget, the April update and the Mid-Session projections for 1984. Table 2 shows key aspects of the Mid-Session economic projections out to 1989.

The dramatic improvement in unemployment has led to a markdown of projections of the unemployment rate over the next several years. By the fourth quarter of this year, the unemployment rate is projected to reach 6.8 percent. On the other hand, the forecast of interest rates has been pushed up a little, by 0.8 percentage point on the 3-month Treasury bill rate for the fourth quarter of this year and about 1-1/4 percentage points for all of next year.

In the second half, growth is projected to slow down from the first-half pace to a 4 to 4.5 percent annual rate. Even so, 1984 will follow in the 1983 pattern as one of the strongest years for real growth in the postwar period. In sharp contrast to the record since the mid-1960's, this strong real growth has been achieved at stable and even declining rates of inflation.

Some problems remain. The Federal budget deficit has passed its peak but it is still too large. The down payment plan currently in the process of enactment has been a major help. Future action should center on the reduction of the clearly excessive rate of growth in Federal spending.

Interest rates are higher than we would like to see them, but the interest-sensitive sectors of the economy have actually led the expansion, contrary to the predictions of most economists. Given the continuation of steady, moderate growth in the monetary aggregates, the current expansion can extend into future years with even further gains in employment, production and the standard of living.

Accuracy of Longer-Term Forecasts

Before discussing the budget forecast, I should reemphasize the uncertainty surrounding five-year economic and budget projections.

In the past, longer-term economic forecasts have been far wide of the mark and for that reason, as well as because of changes in laws and policies governing revenues and outlays, longer-term budget estimates have also been badly in error. Major economic forecasting errors are not a recent phenomenon. Look at the record in the late 1970's.

- In early 1977, the Ford Administration and CBO projected real growth rates over the six years from 1976 to 1982 averaging 4.8 percent and 5.2 percent per year, respectively. Actual growth was only 2.3 percent per year during that span. Cumulatively by the end of the six years, those errors amounted to 16.1 percent and 18.5 percent, respectively, in the level of real GNP. Translated into the context of current levels of nominal GNP these errors would be worth about $600 billion and $700 billion, respectively.

- Those same early 1977 forecasts contained almost equally large errors of opposite direction in six-year projections for the rate of inflation, so that total growth of nominal GNP was only moderately in error.

- Administration and CBO forecasts made early in 1979 of real growth for the following six years were about equally wide of the mark. Little more than half those errors were offset by errors in the opposite direction in inflation.

More recently the pattern has been reversed, with forecasts of inflation too high and those of real growth too low.

- For CBO starting with the forecast made early in 1979 and for the Administration starting with the forecast of 1980, each forecast of inflation for the periods ending in the year 1984 was on the high side, some of them by a wide margin. For example, in forecasts made early in 1981, both the Administration and CBO overpredicted the average annual rate of inflation for the four years through 1984 by roughly 3 percentage points (based on levels of the GNP deflator now expected for 1984).

- For CBO starting with the forecast of early 1982 and for the Administration starting with the forecast of a year later, the yearly real growth rate has been underpredicted -- by about 2-1/2 percentage points on average in the forecasts of early 1983, to cite the most glaring example.

Perhaps the most egregious errors of all have been in forecasts of interest rates. The following presents the random walk of forecasts of what the 90-day Treasury bill rate would be in 1984, starting with the forecasts of early 1979 when the Administration of that time assumed a bill rate of only 3.7 percent five years later in 1984.

Forecasts of 90-day
Treasury bill rate in 1984

Date of forecast	Administration	CBO
Early 1979	3.7	7.0
Early 1980	7.0	7.8
Early 1981-Carter	8.5	--
-Reagan	7.0	10.2
Early 1982	9.5	11.3
Early 1983	7.9	7.4
Early 1984	8.5	8.9
Latest	9.5	10.0

Of course, changes in economic conditions can have sizable impacts on the Federal budget. CBO estimates that, over a five-year period, a one percent increase in real growth would trim the fifth year deficit of their baseline budget by $105 billion; a one percentage point increase in interest rates over five years would add $26 billion to the fifth year deficit.

Policy changes can also make a major difference. I think it is either terribly cynical or terribly mechanical to assume that government would choose to remain totally unresponsive to changing economic conditions, and that any five-year budget forecast will remain unaffected by policy decisions.

All of the foregoing imply that both the longer-term economic assumptions and the budget projections on which they are based should be viewed with much skepticism.

Budgetary Results and the Longer-Run Fiscal Outlook

The Mid-Session Review of the budget will be out in a day or two. (The attached charts, except where noted, are based on the April update numbers which are not dramatically different.) The Review will reflect the budget impact of the stronger economy and those portions of the down payment package already enacted, or at least awaiting conference.

I hope we will hear no more talk of $200 billion deficits as far as the eye can see. Our deficits have been helped substantially by the down payment package. Currently, the deficit is estimated at just under $175 billion in 1984, and is expected to decline below that in 1985 in the out-years.

With the rest of the down payment and our budget proposals, the budget deficit is expected to fall from just under 5 percent of GNP in 1984, to between 2.5 and 3 percent of GNP in 1989. State and local surpluses are expected to run between 1 and 1.5 percent of GNP for the next several years. These surpluses will offset much of the 1988 and 1989 Federal deficits, and total government borrowing will not have a significant net impact on the credit markets at that time (Chart 4).

It is important not to underestimate the favorable budget impact of the down payment package, especially when fully implemented. It will put the economy into a far better position to grow its way out of the remaining budget deficit. Over the 1987 - 1989 period, the national debt will just be keeping pace with a growing GNP. With only slightly more restraint in the growth of spending, the debt would begin falling again relative to GNP, and debt service would begin falling again relative to tax revenue and other budget outlays (Chart 5). This would free up increasing amounts of the normal year-to-year revenue growth for deficit reduction and for funding other government outlays.

Thus, the down payment reduces the remaining budget problem to levels which can be handled by reasonable spending restraint on the part of Congress. It does so without repeal of the tax rate reductions and incentives for growth which are also critical to the deficit reduction effort. Growth is the key to the deficit problem. There can be no solution without growth. With growth, the solution is well within reach.

The essence of the Federal budget problem is simplicity itself, although no easy solutions seem to be at hand. Federal tax receipts are running slightly above the normal range on the basis of experience since the mid 1960's. Federal outlays, on the other hand, are living a life of their own, moving far above the range of previous peacetime experience (Chart 6).

Federal budget receipts were 18.6 percent of GNP in FY-1983 and are projected to be 18.8 percent of GNP in FY-1984. Average receipts over the period 1964-1979 were also 18.8 percent of GNP. The future budgetary problem does not arise because the American people are undertaxed. Quite the contrary, under existing law Federal tax receipts will be between 19.4 percent and 19.7 percent of GNP over most of the period 1985-89, nearly a full percentage point above the tax levels that were considered normal before the 1980's.

Outlays are even further above their historical levels. Between 1964 and 1979, outlays averaged 20.5 percent of GNP. The recessions of 1980 and 1981-82 have slowed GNP growth and driven outlays to 23.9 percent of GNP in 1984. They will still be above 22 percent of GNP by 1989 without further restraint on the growth of spending or faster-than-projected economic growth. Most of the total outlays now being projected for the future are in areas that

many now seem to regard as somehow untouchable. That psychology must change if we are ever going to bring Federal outlays under control. In fact, if budget outlays could grow slightly more slowly, perhaps about half as fast in real terms as real GNP, the budget could be well on the way to being balanced by 1989. The same result could be obtained by having GNP grow more rapidly, or some combination of the two.

It matters very much how we close the remaining budget gap. Tax increases and spending cuts are not interchangeable alternatives for deficit reduction. Tax increases worsen the economic outlook and make budget balance that much harder to achieve. Spending reduction frees up resources for faster growth, and reduces the task of making ends meet.

It is sometimes argued by advocates of big government that the Reagan tax cuts were too large. In fact, the tax cuts were barely large enough to offset ongoing tax increases. If the previous tax code had been allowed to remain in place, Federal tax receipts would have kept on soaring. They would have been close to 25 percent of GNP by FY-1989 -- a level without precedent in U.S. peacetime experience.

Over the period FY 1981 -- FY 1989, the 1981 Economic Recovery Tax Act cut taxes by a cumulative amount of nearly $1,490 billion. But there has already been a long list of tax increases (Table 3):

- $650 billion in inflation-induced bracket creep (which fortunately will end with the introduction of tax indexing on January 1, 1985).
- nearly $290 billion by the 1977 Social Security tax rate increases.
- about $310 billion from the Tax Equity and Fiscal Responsibility Act of 1982 (which Congress was supposed to have more than offset by genuine expenditure cuts but did not).
- $28 billion from the gasoline tax increase, $90 billion from the 1983 Social Security Amendments and $9 billion from other tax increases.
- $100 billion from the down payment package implemented by the Deficit Reduction Act of 1984.

These tax increases total more than a staggering $1,475 billion, leaving a net tax cut of just over $12 billion, or a nine-year average net tax cut of about $1.4 billion. The American taxpayer might legitimately be the one to ask: "Where's the beef?"

Just as in the case of nationwide tax receipts, the tax burden on the typical family has been held in check by the Reagan tax cuts. Drastic tax increases have been prevented, but no drastic tax reductions have occurred.

For a typical family earning about $25,000 in 1982, the Reagan tax cuts have roughly offset ongoing tax increases from inflation-induced bracket creep and payroll tax increases (Chart 7). Without the tax cuts, the Federal tax burden would have soared from less than 16 percent of income in 1978 to over 21 percent of income in 1988. The result would have been adverse shifts in take-home pay, labor costs and employment.

Instead, the family's tax burden will remain at between 1980 and 1981 levels, or roughly 17 percent of income. There will still be a slow rise in the tax rate due to payroll tax increases in 1985, 1986, 1988 and again in 1990. Repeal of indexing would send the family's tax burden soaring as under prior law, by about $350 by 1988 and by more than $550 by 1990.

In fact, if the family experiences real wage growth, it will still face bracket creep and rising tax rates. Indexing only protects against tax rate increases due to inflation. As the country's real incomes rise, the government takes a rising share of the rising GNP.

This is an important point. Prior to indexing, the government could profit from inflation. Federal tax revenues and spending could grow in real terms as inflation raised tax rates, even if inflation reduced real GNP and raised unemployment. But with indexing, government cannot profit from inflation. Government gains revenue only from real growth, real wage increases, and reduced unemployment. This is a far healthier situation for the public and the country. It also underscores the point that budget balance now depends on cutting spending and promoting real economic growth, not on inflation, tax increases, and rising unemployment.

We should be concerned with figuring out how to make additional tax cuts to unleash the productive energies of the private sector. Instead, the advocates of big government want to send us on an endless search for more tax receipts in order to chase after uncontrolled Federal outlays.

Recent Inflation Experience and the Outlook

Economic forecasters have not had a good record on inflation. Recent years have seen much bigger gains against inflation than most economists expected.

The consensus outlook is calling for about a 5 percent rate of inflation in the second half of 1984. The Administration has a similar forecast, but it is important to recognize that there

is a possibility that once again inflation could come in much lower than projected. Some economists have pointed to recent world-wide commodity price behavior as a sign that disinflation is still continuing.

The following is a representative sampling of indicators which suggest that the disinflationary process is still continuing in important areas.

-- The producer price index (wholesale prices) for finished goods has registered three successive months of no change, and is up only 2.2 percent for the last 12 months.

-- Industrial commodity prices were rising earlier in the expansion but have been very soft in recent months. The Economist index of world-wide industrial commodity prices is off about 13 percent over the last six months in terms of SDRs, and down by about 15 percent from a year ago. Industrial metals prices are down about in line with other industrial commodities. The price of gold has recently been about $350, down from $850 in 1980 and over $400 as recently as March of this year.

-- Spot oil prices are generally below contract prices despite Persian Gulf difficulties, and are down from two years ago. The spot price for Saudi light is $27.20/bbl, down from $28.60/bbl a year ago, and an official $29.00/bbl.

-- Disinflation is showing up in lower farm land values, especially in the Midwest, as the expectations of ever-rising land values have been punctured. Farm commodity prices, which rose so rapidly during the 1970s and early 1980s, are up from a year earlier but are levelling off now in response to the prospects of large harvests this fall.

-- Industrial utilization rates have reached the 82 percent range, about in line with earlier cyclical performance but well below earlier peak levels. There is still slack in labor markets where unemployment rates for key age groups remain higher than at the comparable stage of earlier expansions. Unfortunately the unemployment rate for males aged 25 to 54 was still 5.9 percent in the second quarter. In the comparable stage of five previous post-Korean recoveries the rate was 3.9 percent.

-- Upward wage pressures have been reduced greatly even though real wages are rising. In 1979, 1980 and 1981, growth in nominal compensation ranged from 8.8 to 10.7 percent. Yet prices rose even faster, and real compensation declined, especially on an after-tax basis as inflation raised tax rates. In 1982, 1983 and the first half of 1984, nominal compensation slowed substantially, yet still outstripped price increases, especially on an annual after-tax basis. The index of average hourly earnings of production workers in the nonfarm sector -- our best current measure of wage pressure -- is up at a 3.3 percent annual rate in the last six months -- one of the lowest such six months rates since the mid 1960's. Collective bargaining agreements in the first six months of this year call for average wage adjustments of only 2.6 percent in the first contract year and 2.8 percent annually over the life of the contract, the same as last year's record low for the 16 year history of the series.

Opinions will probably differ on just how much importance should be attached to these various examples of downward pressure on prices. But it is conceivable that mainstream economists may be overestimating the inflation potential in the current expansion just as they have consistently underestimated real growth. Certainly, there are favorable signs that inflation may remain much lower than expected.

The financial markets often seem to have reacted adversely to reports of strong real growth even in the absence of inflationary pressures. The idea that the economy is on the verge of overheating and that the fiscal and monetary brakes need to be applied is at variance with the facts. It would be more in accord with reality to recognize that unemployment is still too high and too much of the Nation's plant and equipment stands idle. Table 4 attached to this statement shows two standard measures of the degree of resource utilization now and at the comparable stage of earlier expansions. In particular, there would appear to be substantial slack in labor markets. The table -- and other evidence -- suggests that the current expansion is still in its early stages and has some considerable distance to go before a relatively full utilization of resources is reached.

Monetary Policy and the Federal Reserve

One of the four major elements of the Reagan Administration's basic economic program when we came to office was a noninflationary monetary policy which would provide for the needs of a growing economy but which would avoid the excessive inflationary money growth of the past. Ideally, monetary growth would have been less volatile over the past three and one half years (Chart 8), but the

bottom line is that the overall policy succeeded and inflation is down sharply.

The Fed's current wariness about the threat of a future outbreak of inflation is understandable, even in the context of the very small price increases of recent months. Inflation has been a stubborn and difficult problem. It would be a serious policy error to squander the progress we have made by reverting to an inflationary monetary policy.

But it is also important that the Fed not overdo a policy of restraint. An overly stringent monetary policy would end up fighting, not price inflation, but real growth. It is therefore important that the Fed be especially alert to the fact that the inflation situation may be developing differently than expected. We feel the Fed should monitor the situation carefully and provide sufficient money and credit to sustain economic growth without rekindling inflation.

Interest Rates and Financial Markets

Aside from the broad problems of achieving the optimal rate of money growth and of insuring that inflation does not reemerge, a major immediate concern of the U.S. monetary authorities must be the level of interest rates. We want them to come down. We have felt for some time that there was ample room for them to fall and that the economic environment in the months ahead would allow them to do so.

Between January and May of 1984, interest rates rose by 1 to 2 percentage points. The 3-month Treasury bill, for example, was up 130 basis points from its January level, and long-term Treasury yields were about 140 basis points higher than at the beginning of the year. The prime rate has risen to 13 percent. And even mortgage rates, which are typically slow to increase, are currently about 130 basis points higher than they were at the start of the year (Chart 9).

By May, both short- and long-term interest rates were substantially above current inflation rates, and, in my view, above inflation rates that are likely to occur in the foreseeable future. Real rates of interest, both short and long, seemed high by historical standards. Of course, some allowance must be made for the improved rate of return on new capital formation encouraged by ACRS, the accelerated cost recovery system, in the 1981 tax bill. Also, financial deregulation permitted savers to share in these growth incentives more than in the past. Nonetheless, it appeared that interest rates were quite high in real terms.

Short-term rates have continued to move higher since May. However, long bond rates have fallen substantially. I hope these favorable long-term interest rate declines reflect a belated

acknowledgment by the market that inflation is down, and an increase in confidence that inflation is down to stay. The recent strong rallies in the stock and bond markets, and the resulting lower long-term interest rates, are long-awaited moves in the right direction. I hope that this improvement in confidence in the long end of the market will soon be matched by a fall in interest rates in the short end of the market. Near term, inflation is certainly low, and uncertainty over the short run should be even less than in the long term.

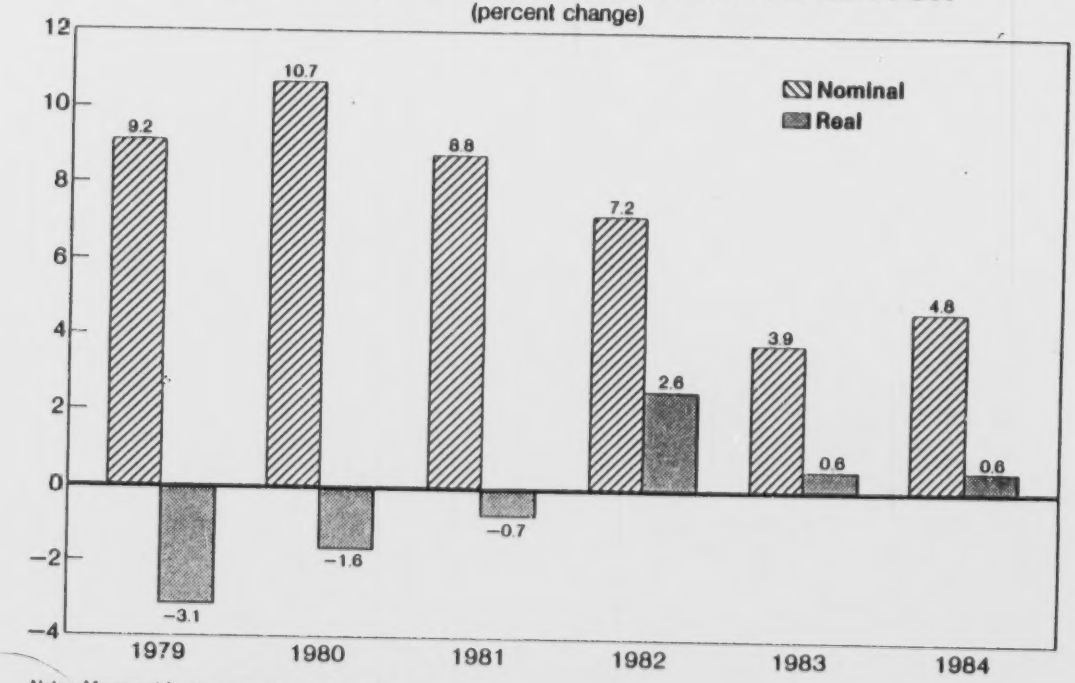
Conclusion

At midyear, the economy is growing strongly and inflation is subdued, if not in full retreat. Non-inflationary growth is the name of the game. It is both the goal of our program and the best means of generating the budget savings and private sector profits, savings and investment needed for growth. It is a self-reinforcing process. To hasten that process, Washington should work harder on spending less, hold the line on taxes, and remove the regulatory straightjacket from American business. That is what American taxpayers want. That is what they deserve.

Chart 1

GROWTH OF NOMINAL AND REAL COMPENSATION IN THE PRIVATE NONFARM BUSINESS SECTOR

(percent change)



Note: Measured fourth quarter to fourth quarter.
1984 is the annual rate for 1st half of the year.

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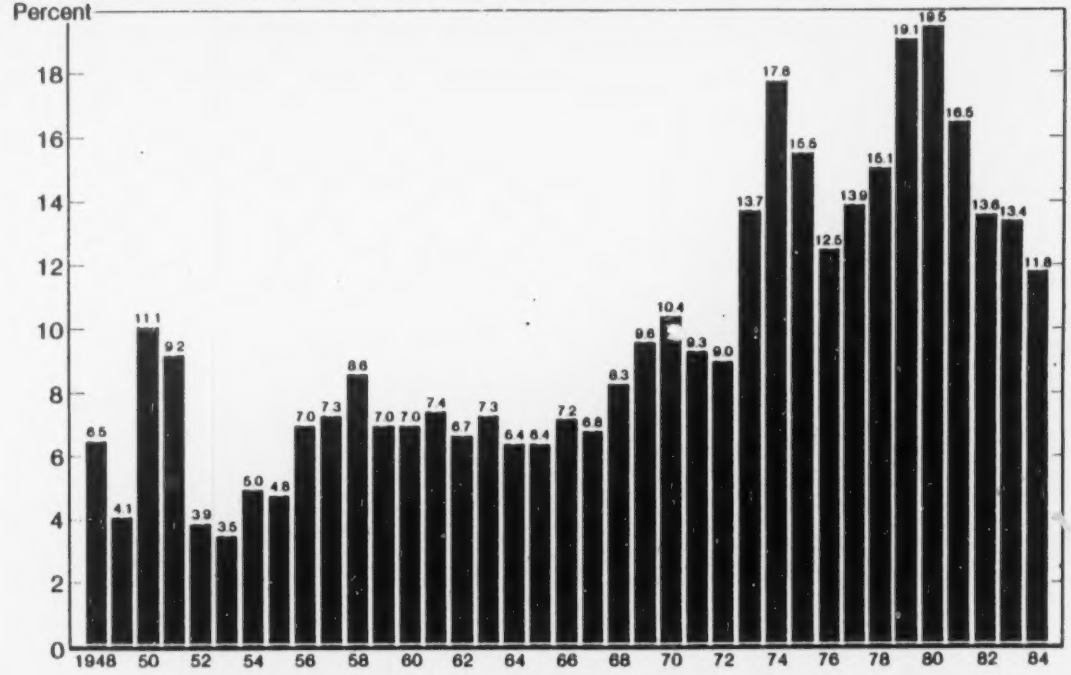
Chart 2

MISERY INDEX FOR U.S. ECONOMY

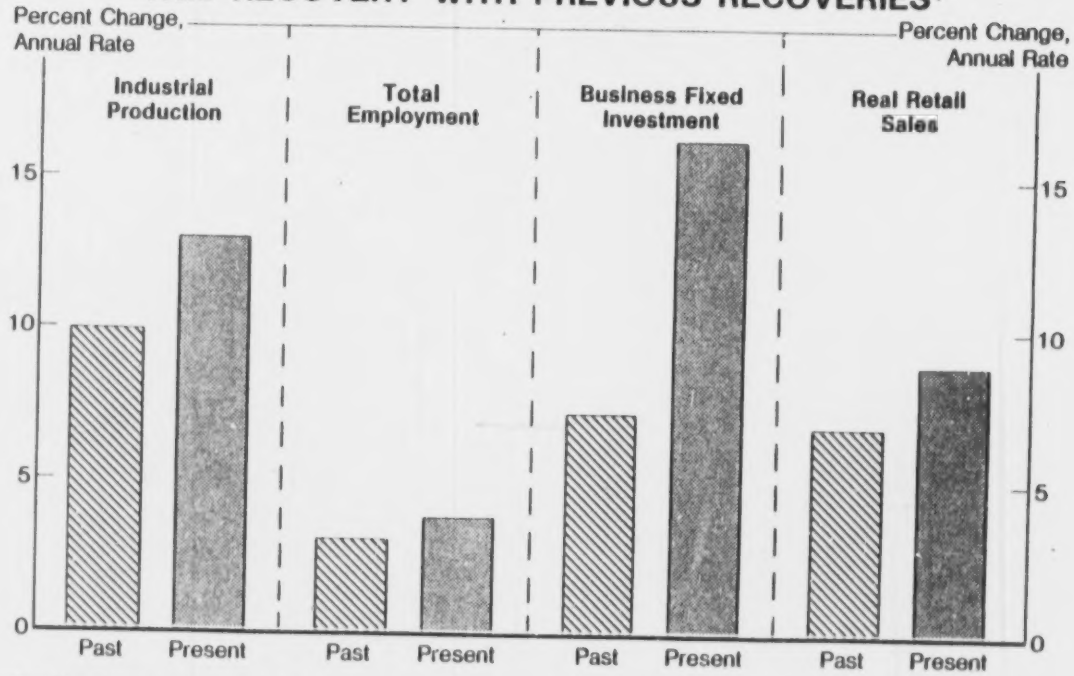


Note: For each year the index is the percent change in the CPI-U on a December to December basis plus the average unemployment rate for the year. 1984 is based on data for the first half of the year.

August 7, 1984 A10s

Chart 3

COMPARISON OF THIS RECOVERY WITH PREVIOUS RECOVERIES*

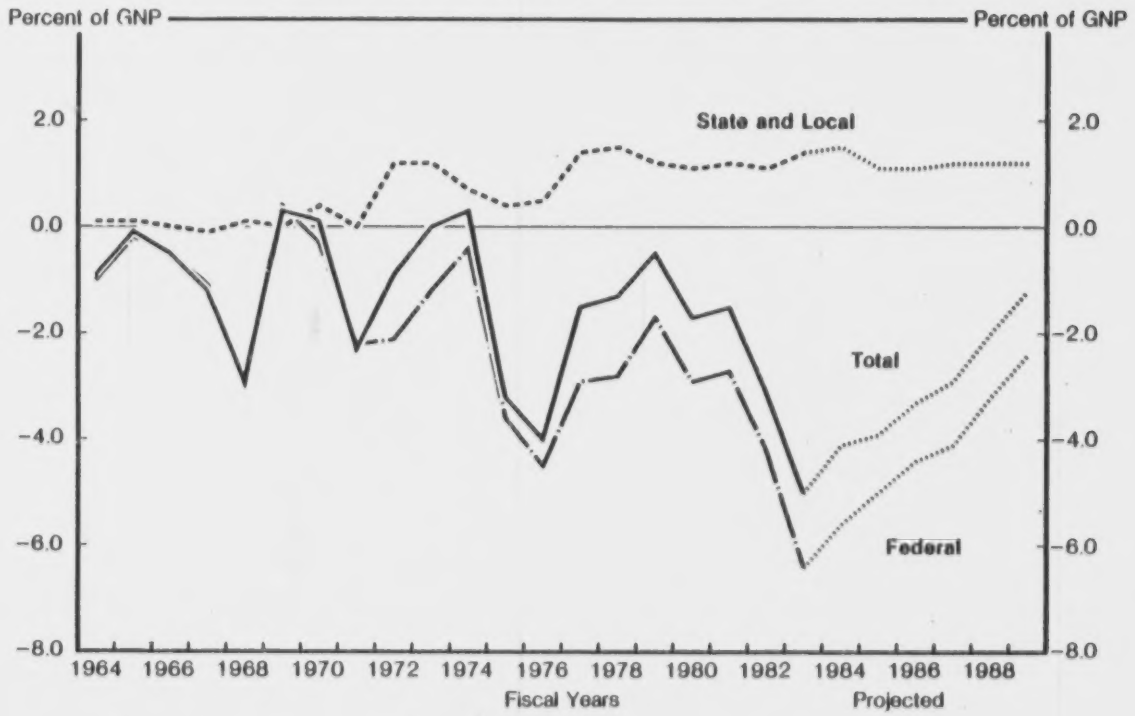


*Post-Korean War recoveries excluding the short-lived 1980 recovery. First 19 months for industrial production and real retail sales, first twenty for employment, and first six quarters for business fixed investment.

August 2, 1984 4:45p

Chart 4

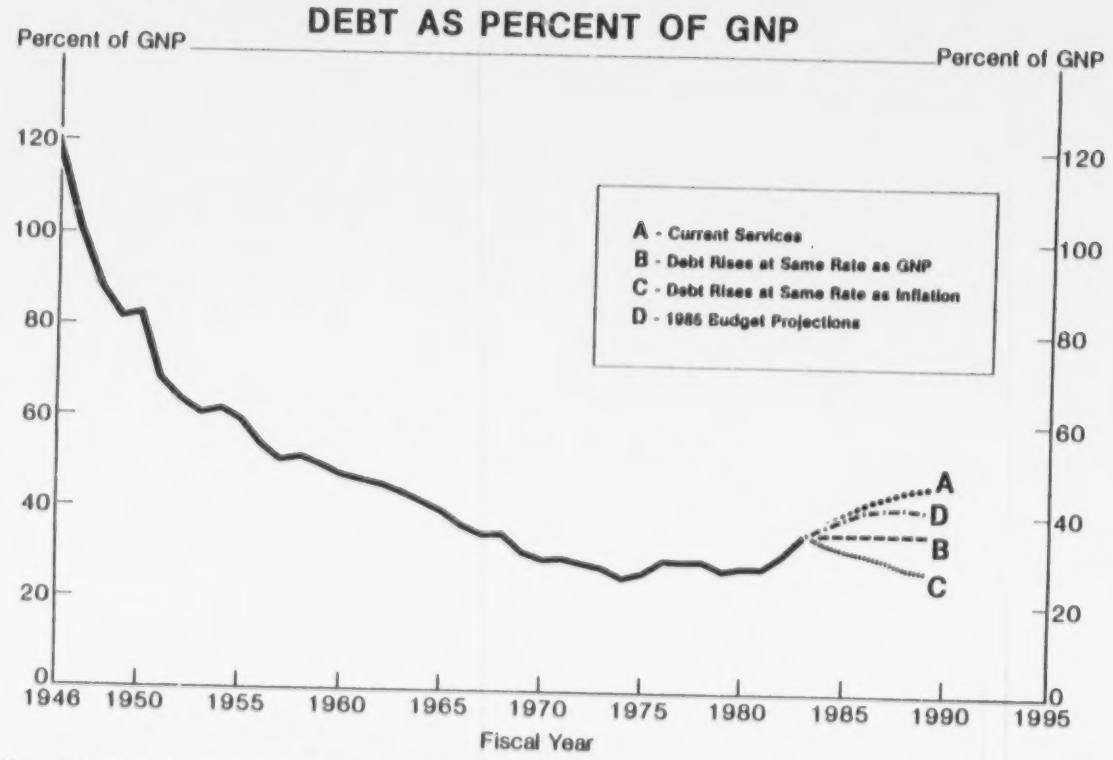
TOTAL GOVERNMENT SURPLUS OR DEFICIT



Note: Federal deficit on unified basis, state and local on National Income Basis.

February 27, 1984 A75

Chart 5

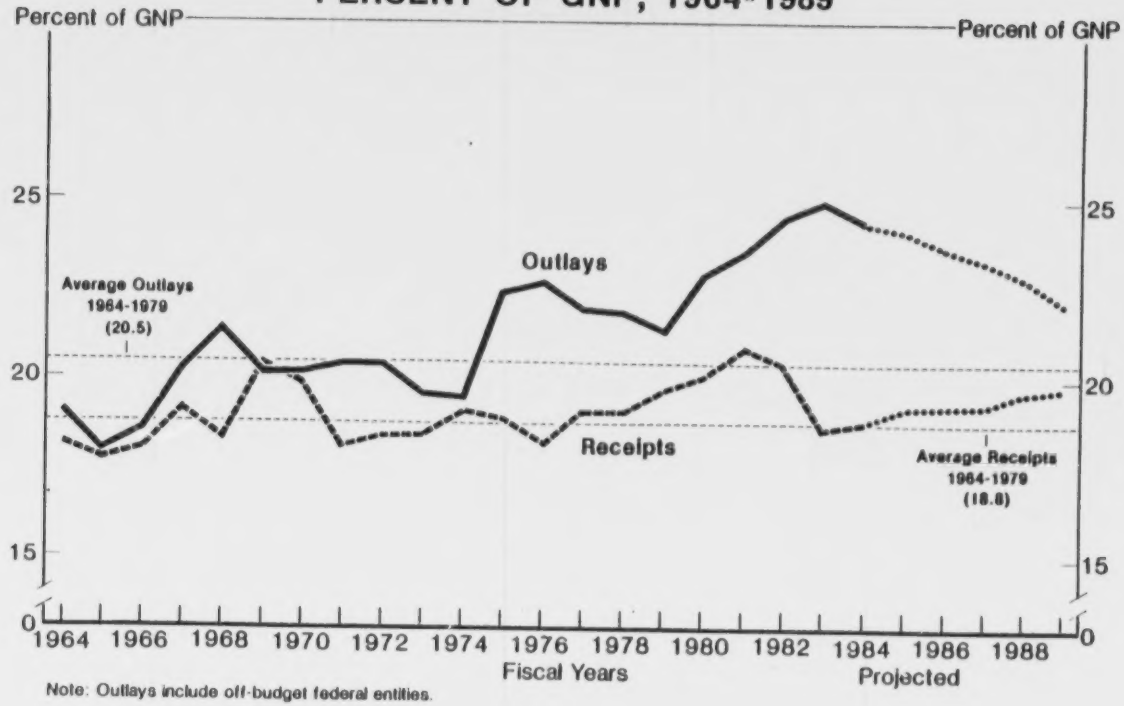


Note: Debt held by the public, including the Federal Reserve.

February 8, 1984 A62a

Chart 6

OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1989



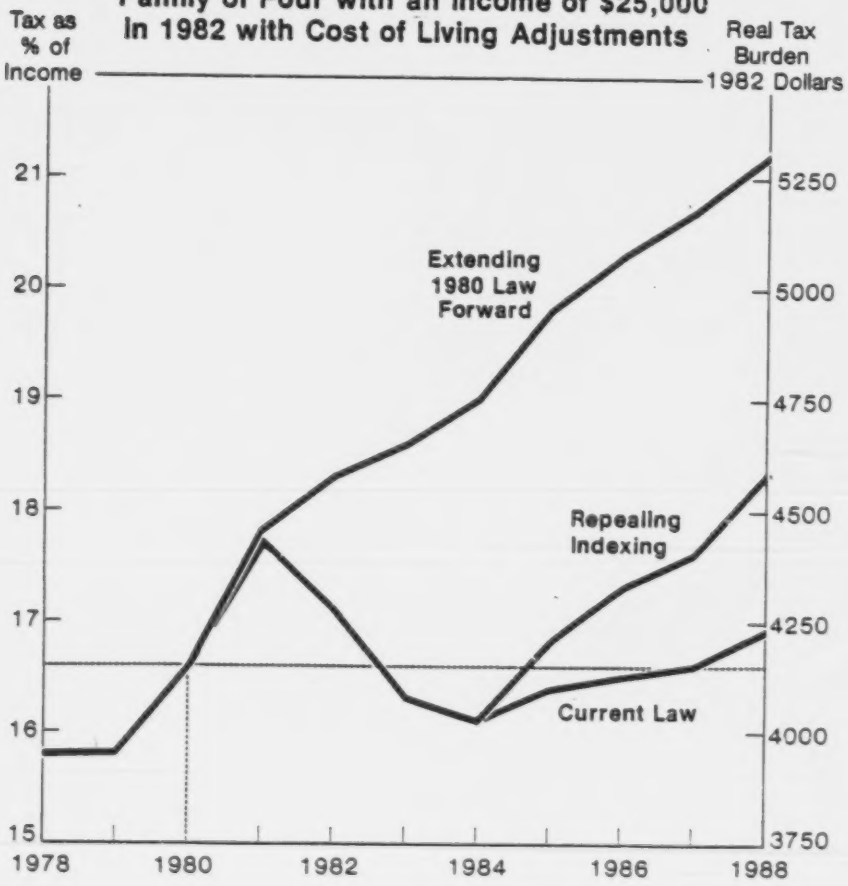
Note: Outlays include off-budget federal entities.

April 3, 1984 A313

Chart 7

REAL TAX BURDEN
(INCOME & EMPLOYEE PAYROLL TAX)

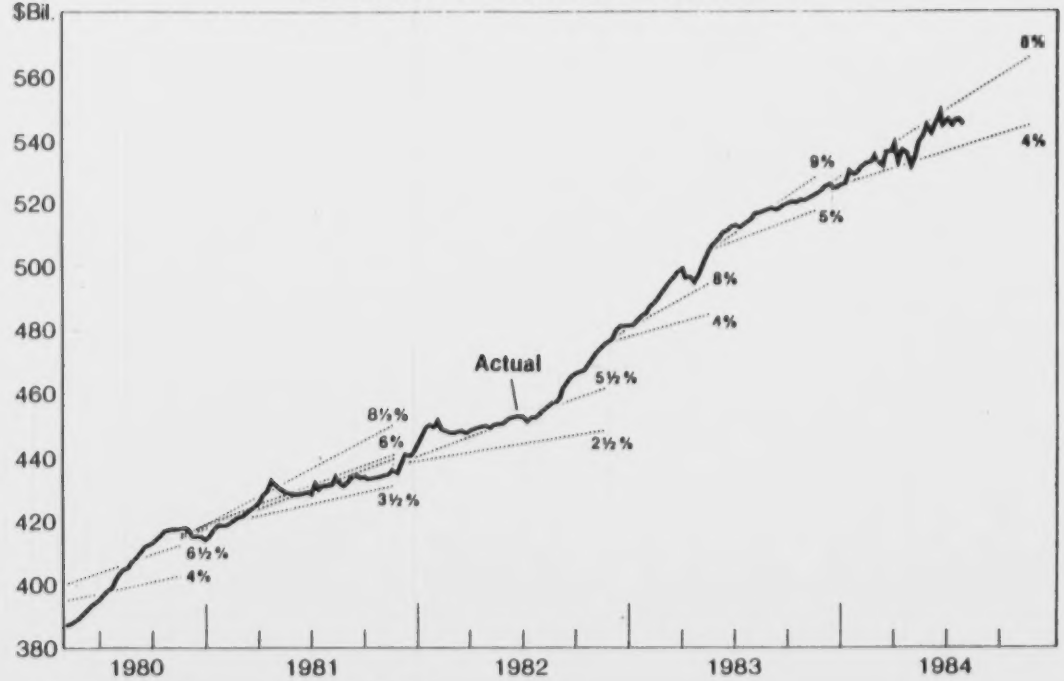
Family of Four with an Income of $25,000 In 1982 with Cost of Living Adjustments



January 25, 1984-A47

Chart 8

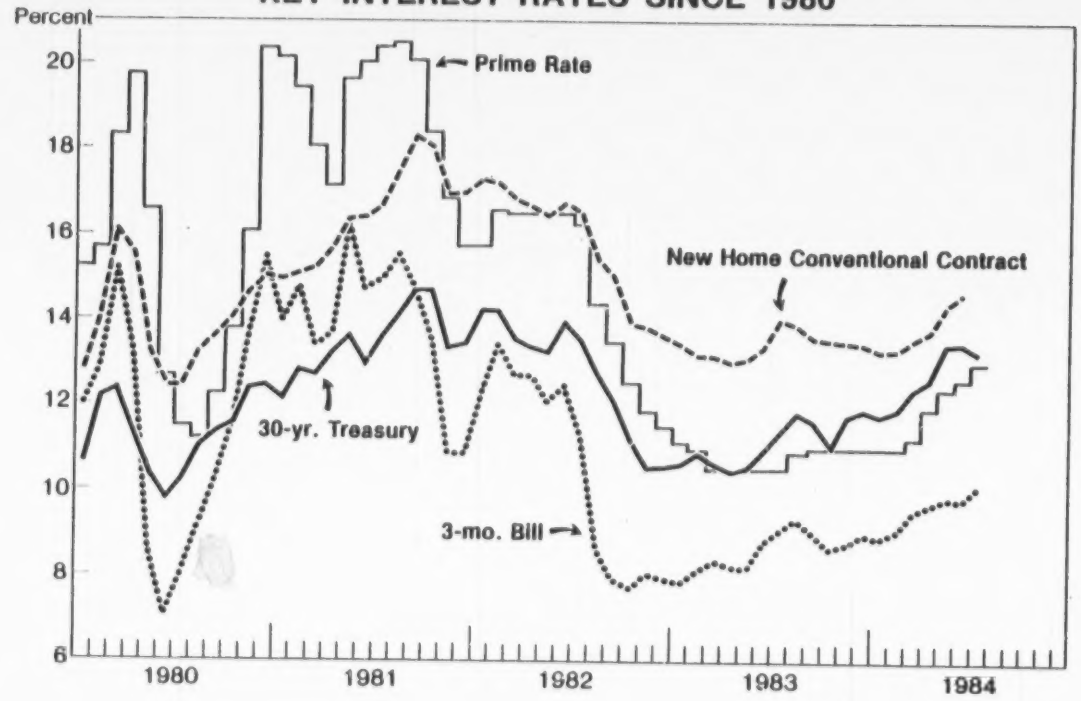
M_1 VERSUS TARGET RANGE*



* M1 data: weekly averages, seasonally adjusted.
Fed target ranges: seasonally adjusted simple annual rates based on quarterly averages.
In 1981 both M1-B and M1-B "shift adjusted" ranges are shown: the M1-B range is 6—8½%; the M1-B "shift adjusted" range is 3½—6%.

Chart 9

KEY INTEREST RATES SINCE 1980



August 8, 1984 A337

Table 1

JANUARY BUDGET, APRIL UPDATE, AND MID-SESSION PROJECTIONS FOR 1984

	Year-to-year			4th-to-4th		
	January Budget	April Update	Mid-Session	January Budget	April Update	Mid-Session
Percent change						
Nominal GNP	10.1	10.6	11.5	9.8	10.1	11.2
Real GNP	5.3	5.9	7.2	4.5	5.0	6.5
Real deflator	4.5	4.4	4.0	5.0	4.9	4.4
Percent (avg. for year or 4th qtr.)						
Unemployment rate*	7.8	7.6	7.2	7.7	7.5	6.8
3-mo. Treas. bill rate	8.5	8.9	9.5	8.3	8.8	9.6

* Based on total labor force, including armed forces stationed in this country.

August 8, 1984 A338

Table 2

THE MID-SESSION ECONOMIC ASSUMPTIONS

	1984	1985	1986	1987	1988	1989
			Year-to-year			
Percent change						
Nominal GNP	11.5	9.2	8.7	8.4	8.1	7.6
Real GNP	7.2	4.3	4.0	4.0	4.0	3.9
GNP deflator	4.0	4.7	4.5	4.2	3.9	3.6
Percent (avg. for year)						
Unemployment rate*	7.2	6.6	6.4	6.2	5.9	5.7
3-mo. Treas. bill rate	9.5	9.3	8.5	7.2	5.9	5.1
			Fourth-quarter to fourth-quarter			
Percent change						
Nominal GNP	11.2	8.9	8.6	8.3	7.9	7.4
Real GNP	6.5	4.0	4.0	4.0	4.0	3.7
GNP deflator	4.4	4.7	4.4	4.1	3.8	3.5
Percent (fourth quarter)						
Unemployment rate*	6.8	6.5	6.3	6.1	5.8	5.7
3-mo. Treas. bill rate	9.6	9.1	8.1	6.7	5.5	5.0

* Based on total labor force, including armed forces stationed in this country.

August 6, 1984 A339

Table 3

WHAT IS LEFT OF THE TAX CUT?

FY 1981 — FY 1989

($ billions)

			Fiscal Years 1981 through 1989
Tax Cut:	Economic Recovery Tax Act of 1981 (ERTA)		—$1,488 billion
Tax Increases:	Inflation-Induced Bracket Creep	+$650	
	1977 Social Security Tax Rate Increases	+$287	
	Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)	+$311	
	Gasoline Tax Increase	+$ 28	
	1983 Social Security Amendments	+$ 90	
	"Downpayment"	+$101	
	Other	+$ 9	
Total Tax Increases			+$1,476 billion
Net Tax Cut			—$ 12 billion
Nine Year Average Net Tax Cut			—$ 1.4 billion

August 6, 1984 A57

Table 4

MEASURERS OF UTILIZATION IN THE SIXTH QUARTER OF CYCLICAL EXPANSIONS

Quarter of cycle trough	Manufacturing capacity utilization rate		Civilian Unemployment rate			
			Total		Males 25 to 54	
	6th Qtr	Peak	6th Qtr	Peak	6th Qtr	Peak
1954-II	88.6	88.6	4.2	4.0	2.9	2.7
1958-II	80.1	84.6	5.6	5.1	4.3	3.7
1961-I	81.6	91.6	5.6	3.4	4.1	1.5
1970-IV	82.8	87.7	5.7	4.8	3.2	2.4
1975-I	80.1	87.2	7.7	5.7	5.1	3.2
Average	82.6	87.9	5.8	4.6	3.9	2.7
1982-IV	81.7	--	7.5	--	5.9	--

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Senator JEPSEN. Thank you, Mr. Secretary.

To kind of clear the air, Mr. Secretary, first of all, from reports that I've viewed and heard in the press recently and accepting the fact that this is the year for political rhetoric, I have wondered whether you are the Secretary of the Treasury or the head of the CIA. They continue to talk about you developing some top secret plan to increase taxes.

Now I'm sure the members of the Joint Economic Committee would be interested in your clandestine activities. Would you comment on that?

Secretary REGAN. Well, Mr. Chairman, let's get it straight. There are no plans for tax increases in 1985. I will repeat it again, Mr. Chairman. There are no plans for tax increases in 1985 by this administration. Any and all talk of tax increases by this administration—secret, open or otherwise—are untrue and uninformed.

I might add, Mr. Chairman, that we at Treasury were told in public by the President before this Congress assembled in January 1984 to study the tax system. In the President's judgment, the American taxpayers deserved a system, in his words, that was simple, fair, and economically efficient.

The Treasury Department, since January, has undertaken such a study. It is still studying the matter. We have had eight public hearings around the country, not just here in Washington but in various cities around the country. We are studying all types of tax reform, looking at what is happening in other industrialized countries, looking at some of the plans that have been broached by Members of both Houses of Congress; namely, Bradley-Gephardt and Kemp-Kasten, and other tax simplification plans. We've looked at a variety of things.

We have come to no conclusions yet because our study is not complete. We are charged with coming up with that study by December 1984 and we will have it on time.

But I might say this, Mr. Chairman. In that study, what we are trying to do is to study tax reform in the sense of making it revenue neutral. That is, to raise approximately the same revenues each year over the next 5 years as is now called for by our budget forecast. We are not trying to raise taxes by tax reform. I know a lot of skeptics say: "Keep away from tax reform. That's a buzz word meaning tax increase." That is not so and doesn't have to be so.

But I would like to point out, Mr. Chairman, also at this time, that if we do nothing about taxes or if in our simple or fairer tax system we remain revenue neutral, our revenues, as I have pointed out in these charts, grow each year from the growth of our economy. Our projections—and I believe CBO is right along the same lines as we at Treasury—are calling for something between $70 and $90 billion of additional revenue each year without raising taxes. Not doing a thing to the tax system, revenues increase by $70 to $90 billion each year. So much so, that by 1989 we will have $400 billion of revenue more than we have currently in 1984.

Now the idea then, Mr. Chairman, becomes, if we want to reduce the deficit, not to spend all of those additional dollars. If we are going to take in more revenue, the worst thing to do is to take in $400 billion and spend $500 billion.

What should be done is to take in $400 billion and spend $300 billion.

Now notice what I said. We will have more revenues. This does not mean cutting the Federal budget. What this means is cutting the rate of increase in the Federal budget. That's what we are talking about.

So again let me repeat, Mr. Chairman, there are no plans for tax increases in this administration. We have no secret plan. We do not intend to raise taxes in 1985.

Senator JEPSEN. So noninflationary growth is the chief goal of the administration's economic policy: that would be an accurate statement?

Secretary REGAN. Exactly.

Senator JEPSEN. The heart of that policy is to reduce the rate of Federal spending, hold the line on taxes, permit economic growth and thus contribute to balancing the budget.

In fact, we should be looking for ways of making additional tax cuts to increase the productive energies of the private sector.

Secretary REGAN. That would be the best of all worlds, Mr. Chairman, if we could get tax rates coming down, not up, because that's what people want and that's what people respond to.

Senator JEPSEN. Chairman Volcker testified before this committee last week. He stated that monetary restraint would remain approximately at the present level throughout this year.

As you know, in the agricultural community in this country, there are some unique and some very serious problems which you alluded to when you talked about the disinflationary effect it had on lowering the value of land. In 1970, the value of land and the pyramiding of land as assets got into the lending-borrowing picture and caused some serious problems.

There are two things that would help the agricultural community immediately. One would be lower interest rates and the other would be higher exports. These solutions are a simple answer to a problem, but would be sort of a quick fix.

I think that we can do something about both. In the last couple weeks with Chairman Volcker and with you here today the one solution this committee has addressed itself to would be the interest rates.

How do you expect interest rates to respond to Chairman Volcker's statement? I saw what happened to the stock market. We all saw that. I don't know if that was in response to his statement or other reasons. But what do you feel the interest rates are going to do the balance of this year, and what conditions in the economy are conducive to a softening of the rates if the Fed holds to a steady course?

Secretary REGAN. Well, Mr. Chairman, that's a complicated question and there are no simple answers. I will try to make mine as succinct as possible.

If you look at the short-term rates and look at inflation and the rental value of money, if you look at the demand for funds and the supply of funds, all of the indicators, in my judgment, would indicate a lessening of interest rates between now and the end of the year, for this reason.

We do expect that this economy's rate of growth is going to slow down in the third and fourth quarters, the quarter we are in and the quarter to come. I think most economists are in agreement on that. Indeed, the leading indicators and several other factors seem to indicate that there will be this slowdown in the growth rate.

If that comes about and if business doesn't accumulate too much inventory, I would suspect there would be less demand for money in the short end of the money market.

At the same time, there will be a good supply of funds in the short end of the market, not only from the normal sources of savings and from the large money funds who have been sitting on idle cash, but from the fact that business profits have been good and they will be looking for a temporary haven for some of these profits until such time as they're expended for future plant and equipment or dividends or what have you. Accordingly, these sources of supply should remain there.

The trade imbalance that we have invites capital to come to these shores. I suspect there will also be additional demand for securities—a supply of funds—in the short end of the market from Europe, from the Far East, for investment in our marketplace.

Put this all together, and it does spell out factors that should lead to a decline in interest rates. I don't see that inflation is going to be rampant in the third and fourth quarters of this year. Therefore, there shouldn't be that fear in the marketplace either.

So all of it put together indicates to me the same thing happening in the short end of the market as has happened in the long end of the market over the past 5 or 6 weeks, and that's been a decline of 100 to 150 basis points.

Senator JEPSEN. Thank you.

Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Chairman.

Mr. Secretary, you have a statement in your prepared statement that says that the Federal budget has passed its peak.

Now do I understand from that statement that the Federal budget deficit has passed its peak, do I understand from that statement that you expect the deficit from this point on to be going down?

Secretary REGAN. That's correct.

Representative HAMILTON. And we're now at the height of the Federal deficit, in your judgment?

Secretary REGAN. I think the height was reached in fiscal year 1983.

Representative HAMILTON. All right. Now let's talk about the tax plans again. My understanding of recent statements from the administration is that you have articulated in recent days three separate positions.

The first position was by the President—no increase in personal income taxes. That statement certainly left open the possibility that other taxes might increase.

The second statement was by Vice President Bush. His statement was that any President is going to keep his options open and he talked about revenue increases. That's kind of an open-ended statement. Anything could happen under that statement.

Then the third statement, again by the President, was, "I have no plans for a tax increase, will not allow any plans for a tax increase."

Now those are three separate statements. They are different statements. It is not, therefore, unusual that a good bit of confusion has arisen with regard to the administration's position on tax increases.

If the position in the administration is as you cited today, no plans for tax increases in 1985, then why do we have these three separate statements, two by the President and one by the Vice President, which are not consistent with one another?

Secretary REGAN. Well, it's hard for me quite obviously, Congressman Hamilton, to try to explain exactly what went on out 2,500 or 3,000 miles away in the course of a press conference with the Vice President and a lot of reporters and what he was saying and just how much came out. You and I both know that many times only one thing comes out of a long press conference. Accordingly, these things are subject to misinterpretation.

But I can assure you, sir, that I have gone over this very carefully, knowing that someone might bring this up this morning. I wanted to be absolutely sure that I was iterating and then again reiterating the administration's position on taxes. Being the Secretary of the Treasury and in charge of taxes for this administration, I certainly, if anyone, should be aware of any plans for tax increases and the like.

And I will again repeat what I said to the chairman, that this administration has no plans for tax increases in 1985.

Representative HAMILTON. Now does that mean, Mr. Secretary, in the studies that you are now making you have been instructed by the President that in any of those studies you're not to consider a tax increase of any kind for 1985?

Secretary REGAN. Right. The idea is, to use that phrase again, to make it revenue neutral. That is, to have approximately the same revenue level coming out of any tax simplification plan as is already projected in the budget for 1985, 1986, and the like.

Representative HAMILTON. So, for example, if you wanted to recommend a flat tax you'd make sure that its revenue impact would not be greater than the present revenue code?

Secretary REGAN. That is correct.

Representative HAMILTON. If you wanted to recommend a national sales tax or a VAT tax or some other kind of a tax that we do not now have, you would presumably recommend reductions in other kinds of taxes so that the net impact would be the same? Is that a fair interpretation?

Secretary REGAN. That is correct.

Representative HAMILTON. And likewise, with regard to a tax on expenditures.

Now that means that you want to tackle the dificits that are out in front of us, and those deficits are very, very large, by spending reductions and, of course, that's a legitimate position. But if it is your position to tackle those deficits solely by economic growth and spending reductions, then it does seem to me it's incumbent upon you to tell us where you are going to get these kinds of spending reductions.

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The CBO projections for the deficit, incidentally, do not decline in the years ahead but rise to $263 billion in the outyear 1989. Your projections, as near as we can figure them out, stay very high. I will not try to give the figures. I'm not sure you've released them yet. But they certainly stay very high, $150 to $180 or $190 billion for the deficit.

Now let's assume you have to get that deficit down. That means you have to take $150 to $180 billion somewhere in spending cuts if it's not made up with economic growth. Where are you going to get those spending cuts?

Secretary REGAN. Well, again, no simple answer will suffice here because this is a very complicated problem. As you recognize, right now we are within about 45 days of the beginning of the new fiscal year and we don't have a budget yet for even 1985, let alone haveing a budget for 1987, 1988, or 1989.

Representative HAMILTON. Well, that could be, in part, because no Member of Congress has been willing to introduce the President's budget for the past 3 years.

Secretary REGAN. Yes, but on the other hand that puts the responsibility right on Congress for producing its own budget.

Representative HAMILTON. That's right and puts a responsibility on you to put forward a budget that we can work on.

Secretary REGAN. We thought that we had.

Representative HAMILTON. Well, you didn't.

Secretary REGAN. Well, that's your judgment, but our judgment was that it was.

Representative HAMILTON. That's not my judgment. That's the judgment of the U.S. Congress. We haven't worked on your budget.

Secretary REGAN. Again I submit the U.S. Congress could be incorrect because the U.S. Congress has had the budget authority all these years and they're the ones that have racked up these deficits and they will continue to rack up these deficits if they don't get it under control.

Representative HAMILTON. Now wait a minute. Not one dime is spent under the Constitution of the United States without the approval of the Congress and the President. Don't tell me it's only the Congress that racks up the deficits.

Secretary REGAN. That's absolutely correct, sir, that the President has to accept these things or else bring the entire government to its knees because we have to carry on these essential functions.

Representative HAMILTON. Then the President bears responsibility for those deficits, this President, past Presidents, just as much as the Congress does.

Secretary REGAN. But you will also admit that the Congress accepts the first responsibility for them because they originate them.

Representative HAMILTON. I admit that the Congress accepts the responsibility. What I object to is your saying that it's the sole responsibility of the Congress.

Secretary REGAN. Well, then, if the Congress would give the President the right to have a line item veto he could go through some of these things that he doesn't want, to knock them out. But the Congress has consistently refused to allow the President to use the line item veto.

Representative HAMILTON. Now let's get back to my question on the spending cuts.

Secretary REGAN. I beg your pardon.

Representative HAMILTON. Mr. Secretary, let's get back to my question on the spending cuts.

Secretary REGAN. Well, all I'm suggesting is that by our very interchange here of opinions this is a complicated problem. Now what I have suggested in my prepared statement was that outlays will be increasing year on year. Outlays are scheduled to increase using just the April figures, not even the new figures, by almost 10 percent for total outlays in 1985 over 1984; 7 percent in 1986; almost 8 percent in 1987; and almost 6 percent in 1988 and so on.

Now what I'm suggesting is that if that were held down by 2 percentage points—in other words, instead of increasing 10 percent, increase it 8 percent; instead of increasing it 7 percent, increase it 5 percent instead of increasing it 8 percent, increase it 6 percent, over the 5 years; and including our increase in revenues, we would actually get close to a balanced budget.

Now, that doesn't mean any cutbacks in Federal spending as a whole. It merely reduces the rate of increase in Federal spending.

Now when we come to a budget, it's difficult for Congress for many years to even pass a budget. We operate under continuing resolutions. Now, that being——

Representative HAMILTON. We're having a great deal of trouble with the Senate now, Mr. Secretary.

Secretary REGAN. I understand that.

Representative HAMILTON. We can't get them to pass a budget resolution.

Secretary REGAN. We even have trouble with budget resolutions in the House.

We also have to realize that each year's budget will have to stand on its own, depending upon economic circumstances. You can't say that you're going to do "X" in 1988 because you don't know in 1984 whether in 1988 we're going to be in the middle of a recession, whether we're going to be in the middle of a boom, or what the economic factors will be.

Representative HAMILTON. Let me just say that my impression, after all of this, is that you have not put forward any very specific area of the budget that you are prepared to cut. There is no indication that this administration will cut anything out of defense. Indeed, the contrary. That leaves you with interest on the debt. You can't cut that. That leaves you with two other areas where cuts might come. One is in entitlements and the other is nondefense discretionary spending. We are talking about reducing deficits here under your plan by cutting spending somewhere in the neighborhood of $100 billion or more, cutting spending that much. Total nondefense discretionary spending is in the range of $150 billion. And let me repeat my point again, that if it is the position of this administration that you're going to get us toward a balanced budget by cutting spending, then the responsible position, it seems to me, is to tell us exactly where you are going to cut spending, what programs you are going to cut, and how much you are going to cut them by, so that the American people then can make a judg-

ment in November between your program and the program put forward by the Democratic Party.

Thank you very much.

Secretary REGAN. Well, there are a couple of comments I could make on that, Congressman Hamilton.

First of all, as you know, the Grace Commission has made quite a few recommendations and some of theirs were based on an inflation factor that was more prevalent in 1982 than is prevalent in 1984. Nonetheless, those suggestions are out there.

About 17 percent of their suggestions have already been adopted by this Congress and the administration, at a total savings of about $40 billion. I would suggest there is a lot more right there in that area that can be done.

And the second comment is more of a political one. If the administration is being asked, I think the same thing applies to the candidate of the other party who is charging that he can cut deficits by two-thirds to also indicate where and which taxes he would raise.

Representative HAMILTON. He's been very specific about tax increases, but the point this morning, Mr. Secretary, is that Mr. Mondale is not before us and you are.

Secretary REGAN. I understand and I indicated to you that at the appropriate time when budgets are called for annually we will come up and show you where the cuts are if we can get the Congress to go along with us.

Senator JEPSEN. Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman and my colleagues on the committee and, Mr. Secretary, I appreciate your excellent testimony and I do also appreciate the good news that you have been able to bring to us.

Just to continue the line of questioning that my good friend, Congressman Hamilton, brought up here, I would only say that in view of the fact that the U.S. Constitution gives the primary responsibility for taxing and spending to the Congress and the Constitution, in my reading of it, doesn't even mention the fact that the President is supposed to send a budget message over here, my only advice to this President would be the next time he sends a budget over, send it over that's lower than what the Congress will do, because in this round we have these very able Members of Congress and it gets a little confused out there in Caldwell, ID, and places like that because people wonder why it is that the President's budget is as big as it is. Now he's been nice about it and tried to be realistic and I understand all the arguments, but I would hope he would just send a budget over here that did call for a balanced budget in a reasonable length of time, 2 or 3 years, and take a little bit out of everything and just let the Congress chew on it and then let them go home and explain it to their constituents, instead of trying to be—you know, I'd like to make a real hardball game out of this budget because I agree with what you said.

My question was going to be what about the taxing. I think you answered that very well. Tax increases are not inevitable unless Congress refuses to reduce spending. And that will take a bipartisan effort and an effort by the administration to jointly tell the American people we have to stop increasing everything. And I

don't think that would put a hardship on any particular group of Americans if it was done properly.

I personally have supported a slowing down of the rate of growth of entitlements. I tell my constituents that and they understand it and appreciate it. I think with some proper work on that entitlement thing we can save money.

But I want to come back now to the question that Senator Jepsen was talking about, and that's about interest rates.

I come from a resource-producing State. We produce agricultural products. We produce timber. We produce minerals.

There was an interesting article in the Wall Street Journal yesterday by an oil man from Norman, OK, Bill Dutcher, who said he had been a great supporter of Reagan, but he found out he could make more money in the oil business if he supported a President who was antioil companies and proconsumer because under Reagan he asked for free enterprise and he got it, and what happened was the consumers get a better deal, the price of oil is down and continues to go down and he reduced tax rates like he campaigned for from 70 percent to 50 percent and there isn't as much tax shelter money available to pay the oil drillers to go out and drill rigs and the price of natural gas has gone down and he's having a tough time, so he figures, he says, "I really can't settle for Ted Kennedy," but he's going to settle for Mondale because he's sure that if Mondale did get elected he would come back with his true hate of oil companies and he says, "Then that way I can figure out how I can make money again like I did back in the 1970's."

But on a serious vein, our problem of producing the resources, the interest rates are devastating to farmers, devastating to timber producers, devastating to mineral producers in this country. And I think the Federal Reserve, in my judgment, has been far too restrictive in terms of their view and their pessimism of what's going on.

Now this morning it's in the Wall Street Journal that the semiannual survey of futures investors, the survey revealed that most of the futures traders now in the Wall Street Journal survey say that the biggest and best buy recommended by the people that they use as their indicator are to buy Treasury bonds because they're expecting interest rates futures to come down which would mean bonds would go up and futures bond prices would go up with the interest rates coming down.

And I talked to a friend of mine who's from Idaho, who now lives in Chicago, yesterday, and he says the biggest resistance to interest rates coming down, he said, "Remember during the 1970's when the banks and the heavy lending institutions had borrowed short and lent long," he said, "There was tremendous big dollar money involved, resisting what was happening of interest rates going up and inflation because it was killing those people who borrowed short and lent long. They were caught in a real squeeze."

He says, "Now they have all reversed their positions and it will take some time to overcome that and the market is going to beat them down and your posture will ultimately prevail over Paul Volcker and over the big bankers and everybody else."

What do you say about that? Is that a factual analysis of what's happening? Is there just so much money out there that they resist

the market? He said the banks have all borrowed long now and lent short and they can't afford to lower interest rates.

Secretary REGAN. No, I don't quite go along with that. I think if you look at the banks' condition at this point and their sources of funds, they are still funding themselves primarily in the short end of the market, not in the long end of the market.

Senator SYMMS. But they are resisting interest rates going down.

Secretary REGAN. Well, that's a natural tendency on any banker's part, to resist giving away the shop. And until the interest rate path is shown to them, they follow rather than lead, so they have to be shown the path of how to get interest rates down.

What I'm suggesting to you is that they will be shown that path by the lack of as much demand as there has been in the past for business loans. The C&I loans over the past several weeks have been fairly flat. That being the case, with a plentiful supply of money and not as much demand, the factors are all there to have a reduction in rates in order to attract more borrowers.

You will notice, by the way, in automobile loans—this is a fact that most people haven't watched—the rate of interest being charged on them to purchase new automobiles is only very slightly up over what it was in the late 1970's. So that end of the market has also shaded quite a bit.

It's in the more publicized rate, the prime rate, that we still have this inconsistency of a very high rate in the short end of the market versus what we see in other phases of the marketplace.

Senator SYMMS. So, in other words, what you're saying here is consistent with today's article?

Secretary REGAN. And also, I might add that as Secretary of the Treasury, for anyone to buy Treasury bonds, right on, man, keep going. We have three issues we're trying to sell this week. As you know, this is our refunding week; 3 year notes were sold yesterday. We have the 10 year bonds today and the 30 year bonds tomorrow.

Senator SYMMS. Wasn't yesterday's sale considered optimistic?

Secretary REGAN. Yes, it was very well received in the marketplace.

Senator SYMMS. But what you're saying here this morning is that with a surplus in State and local government and a reduction in the Federal deficit, that those people who fear crowding out really have nothing to fear?

Secretary REGAN. Well, if you recall, Senator, people scorned my saying in 1983 that we could handle the deficit in 1983, and I think I was scorned again in 1984 earlier on when I said that it's still manageable this year. I did, however, say that we had to get deficits under control and I think what I was indicating has proven to be the fact, that there was not this crowding out phenomenon that most people expected. I still don't see crowding out unless this deficit continues to rise.

Now as I have suggested in answers to previous questions, we do have to start in 1985 getting that deficit down. There's no other way that we can prevent crowding out if we don't get it down, but I think that it is an achievable fact.

Senator SYMMS. Well, I agree with you. My time is up and I thank you, Mr. Secretary. I think the point that we need to make here is also that if we are going to talk politics, which we always

tend to do on election years and I guess that's fair game, that with Walter Mondale running around the country promising more to every special interest group he has no alternative but to raise taxes. If we could make it more popular to promise less to special interest groups, then we could balance this Federal budget with the present flow of revenues that are coming into the Treasury and I have said before that what we need to do is put someone like Peter Grace, who really believes you can cut spending, over at OMB, who doesn't listen to all the prattle from Washington where everybody tells you you can't cut spending because people get around this town and after a few months they begin to believe you can't cut spending because all they run into is special interest groups.

If we had someone in there who believed that we really can cut spending and we don't have to give away the store and everything, I think this can be accomplished. And I think that this President can accomplish a great deal in his second term. I wish he had been more aggressive personally as a Republican in the first term on cutting spending. Certainly you have been in the forefront of talking about reducing spending and not raising taxes, and I compliment you for that, but it is a big government and there are a lot of points of view that get floated around, but here in Washington special interest groups get far too much play and people tend to play to the special interest groups.

When you get outside of Washington you don't hear as much about what the special interest groups want. People want to know why interest rates are still excessively high and why doesn't the Federal Government cut out some of the spending, and they are not that married to any particular part of the Federal Government. They would like to take a little bit out of everything.

I thank you very much for your testimony this morning.

Senator JEPSEN. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Mr. Secretary, I'm going to ask you a few questions about your 1981 forecasts versus what we have seen in actuality. Of course, there have been enormous gaps. And I don't do this to impugn either your terrific ability or professionalism or your equally evident and many times proven good faith and bona fides.

The purpose of this exercise is to indicate my belief that neither party really and neither branch of Government has the economic expertise, doesn't have the stable of economists who can give us projections and extrapolations that over a period of years are going to be too helpful, and I think you have indicated that in your testimony this morning. I think you have indicated that we have to be comparatively modest about projections many years out front, and that is the only purpose of this exercise. Let me just go through it.

In 1981, this administration predicted that we would have by 1984 real GNP of $1.711 trillion and it wasn't that. It was $1.646 trillion, about 3.8 percent short. You predicted an unemployment rate of 6.4 percent. It was 7.3 percent. You indicated that we would have a budget surplus this year of $500 million and, of course, we have had this extremely burdensome budget deficit of roughly $170 billion or $172 billion deficit.

You predicted an interest rate on Treasury bill of 7 percent and the actuality is 9.6 percent.

Again, I repeat, this is not to question either your enormous competence or your just as impressive and historically continuous good faith and square dealing with us. It is to say that economic predictions in a complicated economy like ours is, as you indicated, you don't know 4 or 5 years down the pike whether we're going to have inflation or a boom or a recession and, of course, these things, even a hairline change, when extrapolated, have enormous impacts on these projections.

So I'm taking your suggestion that all of us be modest in our extrapolations and I want to ask you about your projections on the economy this morning.

Your projection of a 4.4 percent real growth in GNP through 1989 and the years before that is higher than we have experienced in any comparable period of recovery previously.

A decline in the inflation rate to 3.6 percent by 1989 seems inexplicible to me. A decline in the interest rate to 5.1 percent in 1989 from where we are today also baffles me, and you take the combination of extraordinarily high growth in real GNP which you have predicted, declining interest rates and declining inflation rates which you have predicted, and the package—the combination is unprecedented.

Now in light of the fact that you're not suggesting any notable change in fiscal or monetary policy, how do you justify this forecast and how can you help us have more credibility in the work of your economic forecasters?

Secretary REGAN. Well, I might start by pointing out, Congressman Scheuer, that as one of my staff characterized me, I'm an economic agnostic. I don't believe anybody can forecast beyond perhaps 12 months because, indeed, it's a very murky crystal ball. As you indicated in your remarks, a very small error gets magnified when it gets on out there, and econometric forecasting depends upon the variables that you put in. What's velocity going to be? Most people don't even understand velocity, let alone what the velocity might be a few years hence. Look at the oil prices—what the oil prices are going to be in 6 months, let alone what they're going to be in 4 years—yet you have to take that into consideration.

So what economists do is to take certain assumptions and then extrapolate, straight line the thing. That's more or less what we have done here and that's why I'm urging caution on these wild statements as to what deficits may or may not be out there or how things could or could not happen.

Now is it conceivable that we could have a good economy over the next 4 years? I think that is the essence of what we're trying to get at here. The answer is yes. It can be done. There have been periods in U.S. history, in post World War II history, when this has been done.

Now growth rates don't always go 4 percent, 4.5 percent. They might go 6 percent and they might go 3 percent. But what we are indicating is that on average this is what will happen.

However, things can be overlooked. I just turned to a page here looking at forecasts made in early 1981 by a lot of people—Data Resources, Chase Econometrics, Wharton, Blue Chip Consensus, who employ economists, as well as the CBO. Everybody missed. Nobody was correct at that period.

As you recall, very few of us—not any, in fact—saw that by July 1981, standing as we were there in February 1981, a recession was coming, particularly a recession of that magnitude. Nobody predicted it, but it happened.

Then, from there, all of the projections had to be revised.

Now can that happen again? It could, but it doesn't have to is what I'm suggesting. What we have done in our forecasts is to say, if business conditions remain good as we think they can, if we are sensible about what we do in the fiscal and monetary areas in Washington, and if we don't kill incentives out there as far as the American businessman and entrepreneur is concerned, we can have good business, and that's all we're suggesting; that there will be good business over these next few years.

If so, this is a path around which the economy might expand.

Representative SCHEUER. Let me ask, what difference would it make in your projections if the Congressional Budget Office is right and by 1990 interest rates are 8.9 percent instead of the 5 percent that you predict, which would give an increase in the budget for 1989 alone of about $80 billion?

Secretary REGAN. One percentage point change in interest rates, based upon the current and expected U.S. debt, is about $26 billion per year if carried out over a period of 5 years. If CBO is at 8.5 percent and we're at 5.5 percent, approximately 3 percentage points difference, three times 26, you would get $78 billion of additional deficit resulting strictly from the difference in interest rates, if the 3-percent differential continued over time.

Representative SCHEUER. That's annually?

Secretary REGAN. Annually. Actually, as for the difference between their $263 and whatever we come in with, less than $78 billion of it could be accounted for by the difference in interest rate assumptions alone, since the difference builds up to 3 percent gradually. The rest is due to different outlay and revenue assumptions.

Representative SCHEUER. Has Paul Volcker and the Fed more or less agreed with the assumptions underlying your predictions?

Secretary REGAN. I would leave that to the Fed to answer for themselves, but I understand—it's my belief that they do not make 5-year projections. I think they restrain themselves and only go out about 12 months, which is a much safer course.

Representative SCHEUER. Discretion being the better part of valor.

Secretary REGAN. If I could make another pitch for that, I alluded in my testimony to the fact that maybe Congress would want to rethink this idea of making 5-year economic projections. What is the sense of it? This committee should debate among themselves the wisdom of this requirement and whether or not in the future perhaps 3 years at most wouldn't be a better course of action in order to focus attention more clearly on what's happening.

Representative SCHEUER. In order to focus attention on the underlying trends that are happening, can you give us the underlying economic and fiscal policy changes or the economic and fiscal policy, monetary and fiscal policy, that underly the assumptions of the projections you have given us?

Secretary REGAN. Well, we assumed that there would be these increases in revenue coming from growth. For the Federal budget outlays, we more or less straight-lined what was happening in the past few years. Those were the two assumptions. For monetary growth it's my understanding that in the short term monetary growth assumptions underlying administration forecasts are consistent with the target ranges announced by the Federal Reserve. Further ahead, the practice is to assume a gradually reduced money supply growth rate in the future as the economy matured and expanded more, which would be consistent with past intentions expressed by the Fed.

Representative SCHEUER. Thank you very much, Mr. Chairman.

Senator JEPSEN. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

Mr. Secretary, I want to thank you for your excellent testimony here this morning.

You mentioned in your prepared statement that growth is critical to the deficit reduction effort. Mr. Volcker has mentioned to the Senate Banking Committee that he disagreed with assertions that further reductions of the deficit could come through economic growth.

Could you explain the difference in opinion?

Secretary REGAN. Yes; what we are stating is that growth will bring in these additional revenues to which I have alluded previously, the $70 to $90 billion year after year, as the economy grows at the rate of 4 to 4.5 percent or so per year.

Some people don't assume that much growth and accordingly don't get the same amount of revenue coming in as we do. Other people despair of this Congress ever reducing the rate of spending. We don't. We think that the Congress itself, as well as the American people, want this and that eventually the rate of spending will be reduced.

If two things were to happen, the increase in real growth bringing in more revenue and the Congress restraining the rate of growth in spending, you can bring deficits down.

Representative SNOWE. Are you suggesting that the $70 to $90 billion revenue increase per year that you're projecting, is based or contingent upon Congress reducing the deficit?

Secretary REGAN. No. That comes strictly from growth. That is no congressional action whatsoever, strictly from growth. It includes, by the way, the fact that we believe that indexing not only will go into effect on January 1, but remains in effect during this period.

Representative SNOWE. This obviously takes into account projections that you made on unemployment rates, interest rates, and inflation rates.

Secretary REGAN. Yes.

Representative SNOWE. And what are your projections?

Secretary REGAN. Interest rate assumptions for calendar years—I'm talking here about 91-day Treasury bills. For 1985, 9.3 percent; for 1986, 8.5 percent; 1987, 7.2 percent; and the like.

As far as unemployment is concerned, the unemployment rate is 7.2 percent for 1984; 6 percent for 1985; 6.4 percent for 1986; 6.2 percent for 1987, and just under 6 percent straight on out. That's

full employment by some definitions. I'm not sure that it is actually full employment.

Representative SNOWE. And finally, one other question. Am I correct in interpreting your statement earlier to Congressman Hamilton concerning tax reform, particularly other tax changes such as a national sales tax, for example. Would any type of tax change come in concert with tax reform?

Secretary REGAN. Well, what I'm suggesting is that we are studying all of these. I am not saying that they will happen. We are studying all these because we must study if we're to come up with a tax simplification plan that we think is the best of all plans. We have to study all those other plans. So we are studying that.

I am not forecasting that there will be a sales tax nor a VAT or any other type of consumption tax. I am merely saying we are studying those before we give the President options in December.

Representative SNOWE. There's been a great deal of speculation, as you might know, concerning it.

Secretary REGAN. I noticed that Mr. Mondale said that I was in favor of a sales tax. I am not in favor of a sales tax. What I said was I'm studying that or we at Treasury are studying that, as we study everything, before we come up with a final report.

Representative SNOWE. But any of those changes would be in connection with tax reform?

Secretary REGAN. Right. And I will repeat again, would not result in increased taxes in our plan.

Representative SNOWE. Thank you, Mr. Secretary.

Senator JEPSEN. Mr. Secretary, because of the campaign, deficits are talked about and will be continue to be talked about for the balance of this year on an increased basis. The simple statement, deficits are the cause of all of our interest rates being high, is often made.

Do you believe that deficits cause interest rates to be high or to remain at their current level?

Secretary REGAN. Deficits cause interest rates to remain where they are at? No, I don't believe that. I think there are many reasons for interest being where they are at, but deficits are not either the most important nor the only reason.

Here I'm going to beg off a detailed explanation because I've read Mr. Niskanen's testimony and I know he's going to get into that, and I think that he will be able to explain a lot more fully our administration position on this. But let me reiterate what I said before. Deficits are important. Deficits are something we should get rid of. But deficits and interest rates and the linkage between them have only a dim connection.

Senator JEPSEN. One of the best kept secrets it seems in this country today is that today's deficits are lower than they were a year ago. For the first 7 months they were substantially lower than they were a year ago.

Why do we not hear more about the deficits heading in the right direction?

Secretary REGAN. I don't know. We certainly have been trying to say that, although I must admit that we're not proud of the fact that we still have the deficit, so we haven't been going around

shouting from the rooftops about the fact that it's been reduced. It's still too high and still should come down even more.

Nevertheless, you are correct. The deficit this year will be more than $20 billion below last year's deficit and the deficit next year will be even lower than that.

Senator JEPSEN. Congressman Hamilton.

Representative HAMILTON. Thank you.

Mr. Secretary, do we have your assurance that the President will not ask for any reduction in Social Security retirement benefits in the second term if he's reelected?

Secretary REGAN. Let's be precise now. State that question once more and state all of it.

Representative HAMILTON. All right, sir. Do we have your assurance that the President will not ask for any reduction in Social Security retirement benefits in his second term of office if he is reelected?

Secretary REGAN. Well, quite obviously, the President of the United States is his own man. I can only speak as Secretary of the Treasury. But let me put it this way. It is my understanidng that the President of the United States has no plans to cut Social Security benefits during his second term in office. To the contrary, the President has promised that he wouldn't do that in a radio address about a couple months ago when he discussed Social Security.

Representative HAMILTON. So then I can assure people that the President will not cut Social Security retirement benefits in his second term of office.

Secretary REGAN. I believe you can.

Representative HAMILTON. You know, you have made some statements about the Social Security. You've talked about the Social Security system straying from its original purpose.

Secretary REGAN. I don't know what branch of the service you were in, Mr. Hamilton. I was a marine and we had two naval expressions we used in the Marine Corps, and one of the more famous ones was, "Not on my watch." May I reiterate what I said about Social Security, this time, hopefully, to get it clear once and for all.

I said late in this decade, meaning 1989 or 1990, we might have to revise Social Security depending upon circumstances. But again, I repeat, not on my watch.

Representative HAMILTON. But again, let's be clear and precise, as you said, and you categorically rule out cuts in Social Security retirement benefits for—I'm adding a new phrase here—current and future recipients of Social Security retirement benefits in the President's second term?

Secretary REGAN. Future—what do you mean by future beneficiaries? You mean unborn people yet to come? Are you alluding to—this is getting to be very hypothetical when you say all future recipients over the next three centuries.

Representative HAMILTON. You want to renege with regard to the third century, do you?

Secretary REGAN. This is getting ridiculous when you get out that far. Let's say that as far as present recipients are concerned, the President has promised that there will be no cuts in Social Security benefits.

Representative HAMILTON. And by current, do you mean those people——

Secretary REGAN. People in the system.

Representative HAMILTON. All right. Now let me ask you, I have been told that you are considering at Treasury whether or not to sell the bearer bonds. Is that correct and have you made a decision on it?

Secretary REGAN. Well, you understand the Congress has given Treasury the power to issue bearer bonds for foreigners when they did away with the 30-percent withholding. It is one of the things we are studing. We have been importuned by numerous Congressmen and Senators, as well as editorialists and various others not to do this thing. We recognize the perils of this.

You understand, of course, that as of this moment there are many U.S. bearer securities that can be bought by foreigners or by Americans who would be tax evaders if they didn't report this income. I'm referring, of course, to Treasury bills. Short-term Treasury bills are not registered and they can be bought in Europe.

Representative HAMILTON. Let me just add my voice to the others, that I would hope you would not decide to issue that type of security because I think it will only encourage tax evasion. But I know that you are looking at it very carefully.

Secretary REGAN. Well, you must remember that I not only have people in Treasury who are responsible for handling the Federal debt and getting the best deal they can in the way of low-interest rates on securities to finance that debt, but also the IRS is part of Treasury and they don't want to lose a nickel.

Representative HAMILTON. Well, we don't need European capital to finance our deficit, do we?

Secretary REGAN. No.

Representative HAMILTON. We are getting quite a bit of it, though, aren't we?

Secretary REGAN. Well, on balance, the percentage of foreign holding of U.S. debt has declined since 1980.

Representative HAMILTON. Now just a question or two about the Continental problem. Why did we devise that scheme so that the bank holding company rather than the bank got the FDIC bonds? As I understand the implication of that, it is that the bondholders then take precedence over the FDIC in the event of a collapse of Continental and that the taxpayer, in effect, is in a secondary position to the bondholder. And had you done it the other way around, that would not be true and the FDIC would be in a priority position.

Am I correct, first of all, in my statement; and, second, why did you do it that way?

Secretary REGAN. Well, first of all, you are mostly correct in your statement. There are a couple of things that I will point out that I don't think are quite true.

We didn't do it, first of all. Let me point that out, that Treasury does not have the call here. The FDIC is the one that has the call here and the question more properly has to be directed to them.

But I think it safe to say at least what has been in the papers and reported in the papers, that there was a disagreement when Treasury's opinion was asked, although we didn't have the final

call, as to the proper way to do it. We did not want the insurance agency, the FDIC, to be in a junior position to the bondholders in the holding company. We wanted that money to be put in the form of either a debenture or directly into the bank rather than the holding company so they would be at least equal to, if not senior to, the bondholders.

The objective of keeping Continental as an open bank we share with the FDIC and the Fed and the Comptroller. That was the proper way to go, in our judgment, because we did not believe that a close bank, the largest bank in the Midwest, with over 2,000 other banks dependent on it in one way or another—either they were loaning them Fed funds or they shared equally in loans with them—with the reverberations that there would be throughout the Midwest in closing that bank, we didn't see in whose good that would be.

Representative HAMILTON. Is it now our policy not to allow any big American bank to fail?

Secretary REGAN. No, no. What we did there in this case is——

Representative HAMILTON. That is not our policy?

Secretary REGAN. That's not our policy. We've gotten rid of the management. We've gotten rid of the board for the most part or will get rid of the board, and in addition, the stockholders who—well, within the last year their stock was at $25 and it's been down into the $3 area. What's left for them is very little.

Representative HAMILTON. How do I explain to my Indiana bankers that you are prepared to bail out Continental but you won't bail out a small bank in Indiana?

Secretary REGAN. Let's get at the facts first of all. From the year 1982 to the current, some 129 or 130 banks have been in trouble. Three-quarters of them have been merged.

Representative HAMILTON. Some have failed. Some have gone out of business.

Secretary REGAN. Very few have gone out of business.

Representative HAMILTON. Some have.

Secretary REGAN. Some have. The largest is Penn Square. But most went the way of, for example, the First National Midland in Texas, the most recent example, which was merged into another bank.

We have no policy of guaranteeing that all banks, big or small, will remain open nor that all will be allowed to fail. Each case is handled on its own merits.

In the case of Continental, as I just explained, we couldn't figure out whose good it would be to close that bank. Certainly it didn't help the stockholders. It didn't help management. It didn't help the board of directors. They are all out or hurt. So really nobody in management benefited from closing that bank or not closing it. It was the equivalent actually of a closed bank, what we did.

Now as far as policy in the future, again I repeat, the three who have the responsibility—the FDIC, the Fed and the Comptroller—will certainly look at each case on its own. If there's fraud or something of that nature involved, they are not going to keep the bank open. On the other hand, if the bank can be merged into some other more successful organization, they will do it. That's what their policy will be.

Now one thing I wanted to correct. You said taxpayer money. Technically, that is not correct. The FDIC is made up of premiums, insurance premiums, if you will, paid by the banks themselves into the fund. There is no taxpayer money directly involved. True, FDIC has a line on Treasury if they ever need it, but in this case they did not need it and it is not taxpayers' money.

Representative HAMILTON. I understand that. Thank you, Mr. Secretary.

Senator JEPSEN. Congressman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

Mr. Secretary, another phenomenon that has been projected in the economy in recent months has been deflation. Do you have any concerns about that phenomenon, particularly in the future?

Secretary REGAN. I talked with several economists who have been indicating they see signs of deflation around. I am convinced, as I look over past recoveries, that most of the commodity prices involved that they see as a deflationary thing will recover. This would be normal in a recovery where commodity prices go down at the early stages of the recovery and then come back strongly later as the recovery matures. I recognize what they're saying. Particularly metal prices, both precious metals as well as copper and aluminum and things of that nature are way down in price. Oil is down. A lot of this has to do with substitute materials. It has to do with the strong dollar.

I see, in sum, low inflation, not deflation, in the future.

Representative SNOWE. So it isn't widespread enough to be concerned?

Secretary REGAN. No, I don't see it.

Representative SNOWE. In the Wall Street Journal recently there was an op ed piece concerning financing on the debt and it recommended some innovative ways in which to lower the debt servicing costs, including the issuance of bearer bonds and indexed bonds.

Is the Treasury considering innovative ways in which to finance the debt?

Secretary REGAN. Again, I want to be careful with my language so we don't come up with a misquote. We are studying all of these possibilities. You will recall that my background is in innovative financing and accordingly I have charged my people in Treasury with coming up with ways for innovative financing that would reduce some of the interest costs on this debt if at all possible.

Whether or not we will adopt these, I don't know at this point. I have made no decision. I will be making decisions over the next several weeks. But at this particular point, all I can say is that we are studying all of these and we have not as yet adopted any one of them.

Representative SNOWE. Thank you.

Senator JEPSEN. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Mr. Secretary, let me nail down and sort of fine-tune our thinking on what ain't going to happen on your watch.

You have told us that there isn't going to be any reduction in benefits for any current beneficiary. Would the definition of current beneficiary include the working stiff, somebody who's working now and presumably paying into the Social Security fund as part

of the contract for a Social Security that that person believes he has with our Government, somebody who isn't receiving the benefits yet, who hasn't retired, but who is currently employed and paying into the fund?

Secretary REGAN. Now you'd better also throw in, if you will, what Congressman Hamilton said, "during Mr. Reagan's second term."

Representative SCHEUER. That's correct.

Secretary REGAN. And my answer to——

Representative SCHEUER. "During your watch."

Secretary REGAN. Yes, that includes current workers in the system during Mr. Reagan's second term.

Representative SCHEUER. Very good. What about changes in the law that would take effect during the second term that would affect people subsequent to that?

Secretary REGAN. We're getting too hypothetical. There's no way I could answer that.

Representative SCHEUER. I think that's a little hypothetical, too.

Let me turn to the work of the Grace Commission for just a moment. You indicated that there were approximately give or take $40 billion possible savings that the President was in a position to make now. I understood you to say that.

Secretary REGAN. They have already been enacted into law.

Representative SCHEUER. OK—have been enacted into law by the Congress or by executive decision?

Secretary REGAN. Mostly by Congress. Many of them are part of the 1985 budget which is currently before the Congress. Some parts of the appropriations have been passed. Some remain to come.

Representative SCHEUER. Could you have your staff prepare for us, identifying those savings that have been made as a result of the effectuation of this?

Secretary REGAN. Excuse me 1 minute. I didn't bring it with me. I was hoping I had it with me so I could give it to you now, but I will do that.

[The following information was subsequently supplied for the record:]

There is not currently an item by item tabulation of the more than $40 billion of Grace Commission-identified savings that have been enacted by Congress or implemented by the executive branch and are in the budget baseline (another $62.6 billion of savings are included in The President's FY 1985 Budget or agreed to in Office of Cabinet Affairs process and pending implementation). The attached document, "Report of the Implementation of the Grace Commission Recommendations," lists examples of the types of savings that have been enacted or implemented by executive decision. The Administration will provide a more complete report of these savings in January 1985 as required by Section 2903 of the Deficit Reduction Act of 1984 enacted by the Congress in July of this year.

39-740 O - 85 - 17

REPORT ON THE IMPLEMENTATION

OF THE

GRACE COMMISSION RECOMMENDATIONS

JULY 18, 1984

A four phase process has been established to ensure that each one of the 2,478 Grace Commission recommendations is thoroughly reviewed.

INITIAL REVIEW

White House meetings have been held to review many of the Task Force reports. Representatives of the Grace Commission, relevant Federal agencies, the Office of Cabinet Affairs, the Office of Management and Budget, and the Office of Policy Development participated in these initial reviews. Consensus was reached to "forward" recommendations for implementation or "hold" recommendations for future consideration. The initial review process will continue through the fall of 1984 and be linked to the FY 1986 Budget process.

FINAL EXECUTIVE OFFICE REVIEW

A final Executive Office review will occur for recommendations where a consensus on implementation could not be reached in initial review sessions. Such reviews will begin after the initial round of reviews is completed.

ACTION/IMPLEMENTATION

Many of the Grace Commission recommendations already have been implemented. And an automated tracking system has been established to ensure appropriate follow-up for all accepted recommendations. Specific plans for implementation will vary according to whether administrative, legislative, or regulatory action is required.

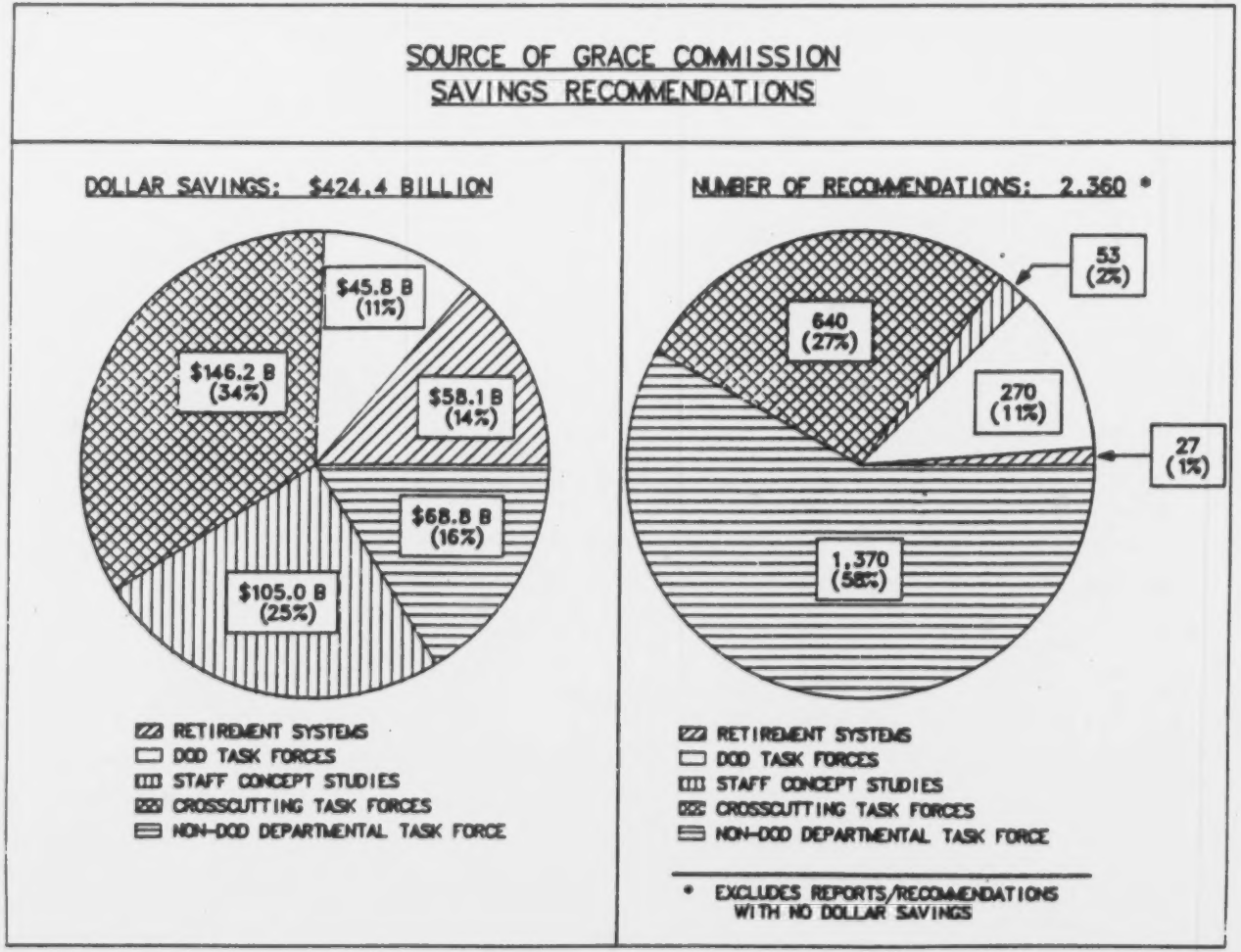
Current Status

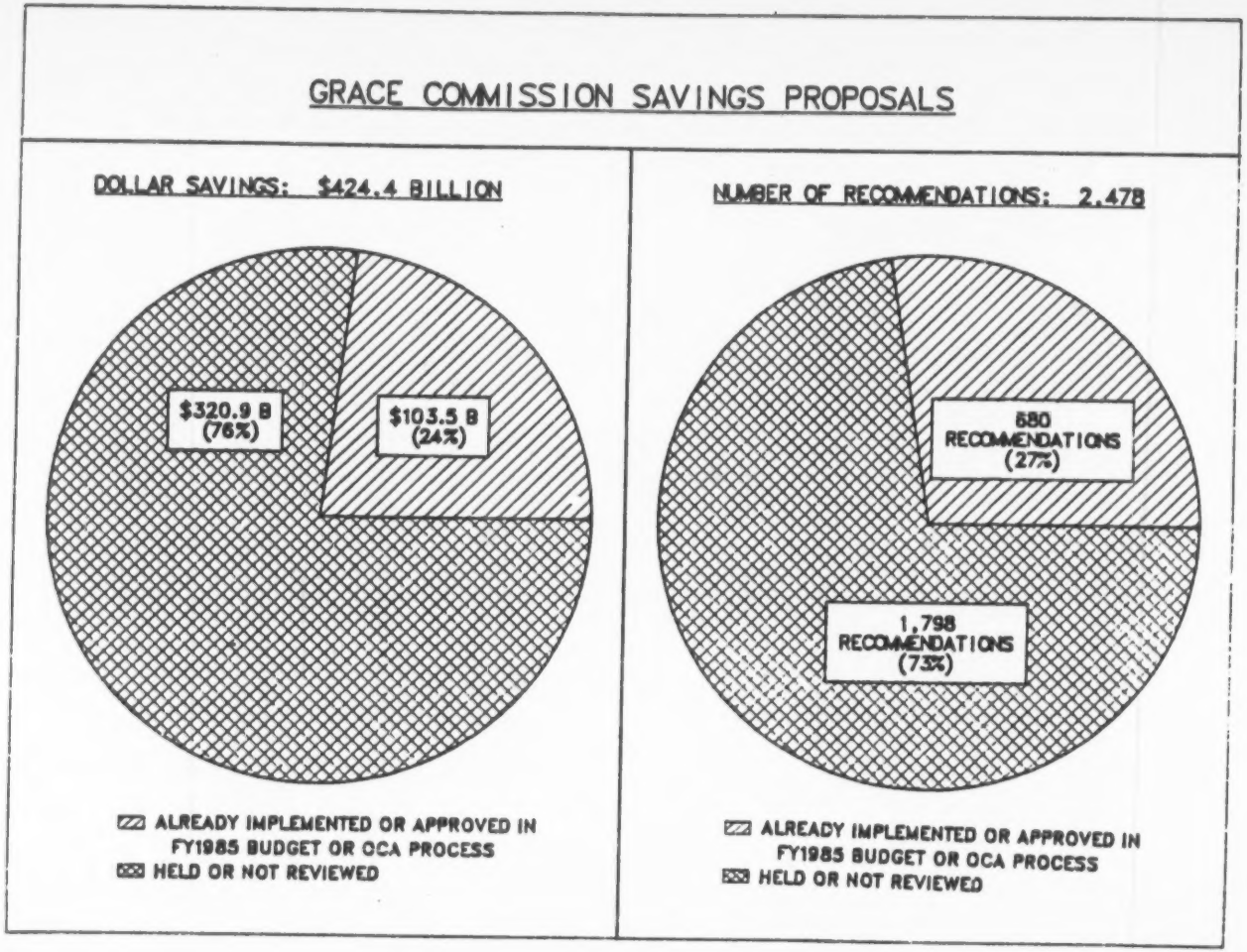
- 15 non-DOD agency Task Force and 5 cross-cutting Task Force reports have cleared the initial review process. These 20 reports represent 346 of the 784 total Grace Commission issues.
- 81.5% of the 346 issues have been forwarded for implementation, 18.5% are being held for further review.
- The 346 issues represent a projected savings by the Grace Commission of $103.5 billion over three years.

FINAL STATUS

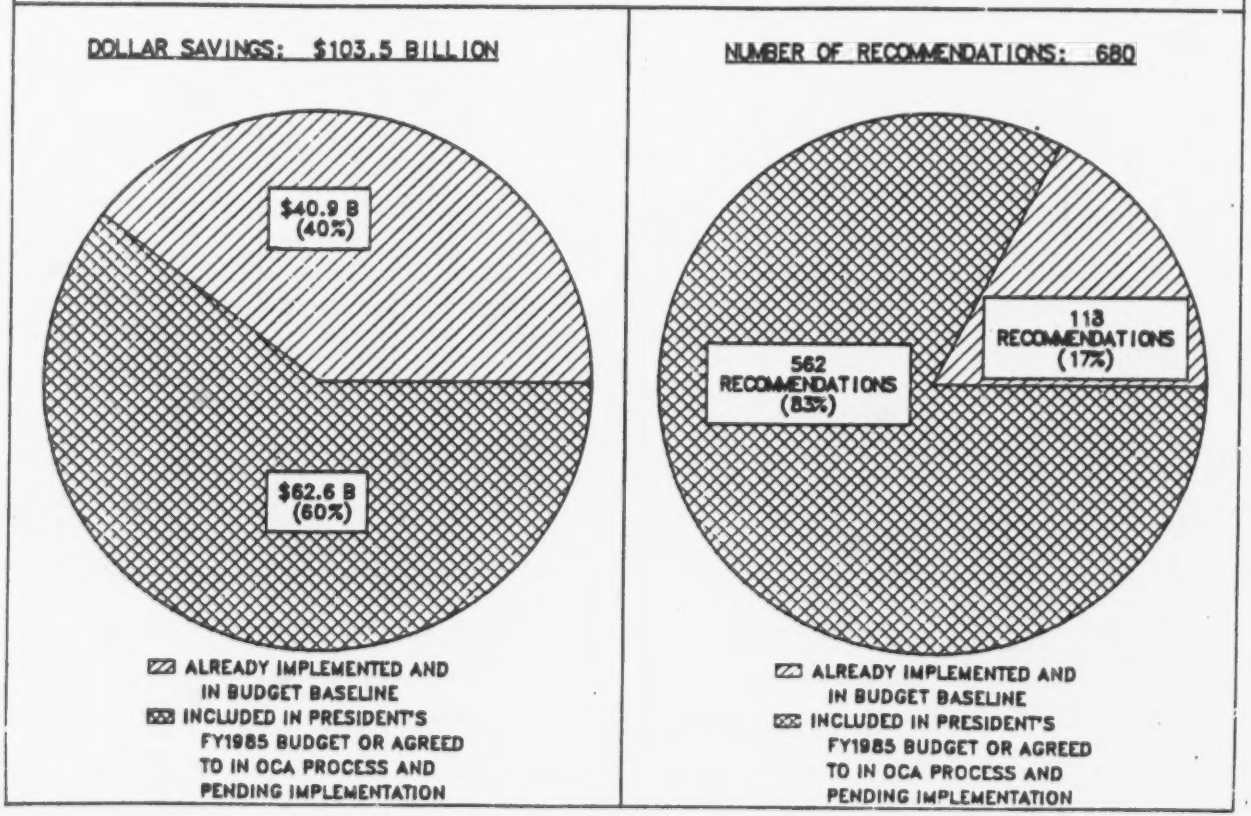
A report detailing the disposition of all recommendations of the 36 Grace Commission Task Forces will be made toward the end of 1985. Updates will be issued periodically during the interim.

SOURCE OF GRACE COMMISSION SAVINGS RECOMMENDATIONS




GRACE COMMISSION SAVINGS PROPOSALS
DOLLAR SAVINGS: $424.4 BILLION
$320.9 B (76%)
$103.5 B (24%)
ALREADY IMPLEMENTED OR APPROVED IN FY1985 BUDGET OR OCA PROCESS
HELD OR NOT REVIEWED
NUMBER OF RECOMMENDATIONS: 2,478
680 RECOMMENDATIONS (27%)
1,798 RECOMMENDATIONS (73%)
ALREADY IMPLEMENTED OR APPROVED IN FY1985 BUDGET OR OCA PROCESS
HELD OR NOT REVIEWED

COMPOSITION OF GRACE COMMISSION SAVINGS ALREADY AGREED TO OR IMPLEMENTED


DOLLAR SAVINGS: $103.5 BILLION
$40.9 B (40%)
$62.6 B (60%)
ALREADY IMPLEMENTED AND IN BUDGET BASELINE
INCLUDED IN PRESIDENT'S FY1985 BUDGET OR AGREED TO IN OCA PROCESS AND PENDING IMPLEMENTATION
NUMBER OF RECOMMENDATIONS: 680
118 RECOMMENDATIONS (17%)
562 RECOMMENDATIONS (83%)
ALREADY IMPLEMENTED AND IN BUDGET BASELINE
INCLUDED IN PRESIDENT'S FY1985 BUDGET OR AGREED TO IN OCA PROCESS AND PENDING IMPLEMENTATION

EXAMPLES OF GRACE COMMISSION SAVINGS ALREADY IMPLEMENTED

- **RAILROAD RETIREMENT REFORMS** — through increased contributions, benefit reductions and other solvency measures ($2,465 million). President signed in PL 98-76 (1983).

- **REDUCE STRATEGIC PETROLEUM RESERVE** — fill rate and Budget cost ($1,059 million) — multi-year fill rate and construction schedule agreement with Congress exceeds recommended savings.

- **MAKE FEDERAL FLOOD INSURANCE SELF-SUPPORTING ($662 million)** — Budget costs cut by 76% already and will reach Grace Commission target of zero in 1987.

- **ACCELERATE FICA DEPOSITS BY STATE/LOCAL GOVERNMENT ($1,664 million)** — "float" largely eliminated in 1983 bipartisan Social Security bill.

- **REDUCE DELINQUENT TAX BACKLOG ($2,722 million)** — Treasury revenue initiative has stopped growth of backlog and raised collections by 61% over 1982 level.

- **INCOME VERIFICATION AND COMPUTER MATCHING OF WELFARE BENEFITS ($2,258 million)** — authority provided in the Deficit Reduction Act.

- **FIXED PRICE MEDICARE REIMBURSEMENT AND EXCESS HOSPITAL CAPACITY REDUCTION ($1,033 million)** — substantially similar efficiencies being achieved through prospective reimbursement (DRG) system enacted last year and implemented in FY 1984. Three-year savings will exceed $5 billion.

- **IMPROVED CASH MANAGEMENT ($2,145 million)** — speed-up the deposit of money received by the Federal government into the Treasury.

- **PROMPT PAYMENT ($2,612 million)** — pay bills on date due and allow state and local recipients of Federal money to draw funds from the Treasury as needed.

- **EFT TRANSFER ($1,581 million)** — increase use of electronic funds transfer to speed cash flow and increase efficiency.

EXAMPLES OF GRACE COMMISSION RECOMMENDATIONS INCLUDED IN FY 1985 BUDGET OR AGREED TO IN OCA PROCESS

- **ENERGY DEPARTMENT OVERHEAD SAVINGS** — Reduce management of GOCO's (weapons research and production); increase competitive procurement and terminate one of three fusion projects ($805 million). Essentially implemented in FY 1985 Budget with three-year outlay savings of $320 million and $95 million cost avoidance.

- **REDUCE CIVIL SERVICE OVERGRADING ($5,164 million)** — 1985 Budget includes 31,000 reduction in GS 11-15 over three years.

- **NAVIGATION USER FEES ($1,346 million)** — 1985 Budget proposes both deep port and inland navigation user fees — with three-year savings of $600 million.

- **REDUCE EXCESS FEDERAL OFFICE SPACE ($234 million)** — Reform 88 project in 1985 Budget with multi-year target for space reduction from 168 sq. ft./employee to 135 sq. ft.

- **FOREST SERVICE STAFFING REDUCTION ($339 million)** — 1985 Budget reduces FTE ceiling to 39,500 — a cumulative 29% staff reduction since 1980 peak.

- **REFORM FEDERAL EMPLOYEE HEALTH BENEFITS PROGRAM ($1,357 million)** — 1985 Budget contains alternate cost control approach which will save $500 million per year after start-up phase.

- **REDUCE HHS BUREAUCRACY AND DEPARTMENTAL LAYERING ($1,101 million)** — 1985 Budget implements modified equivalent of these proposals with three-year savings of $735 million and 5,872 staff reductions.

- **REDUCE INDUSTRIAL BOND TAX SUBSIDY ($5,174 million)** — Modified version proposed in 1985 Budget and contained in the Deficit Reduction Act.

- **PENSION INSURANCE ($324 million)** — 1985 Budget proposes increased pension benefit guarantee premiums to assure pension fund solvency and avoid Federal subsidies.

- **USDA MANAGEMENT ECONOMIES ($608 million)** — Improvements in information systems, reductions in Food Stamp coupon printing costs and other efficiency measures will be implemented administratively or in the 1986 Budget.

- **EDUCATION DEPARTMENT SAVINGS ($1,206 million)** —Improve smaller discretionary grant program management and reduce interest subsidy costs on student loans by delaying lender disbursement until student needs funds.

Representative SCHEUER. We will hold the record open.

Now we understand that approximately a third to a half of that $424 billion of projected savings can be effectuated through executive branch decisionmaking without legislation, is that your understanding, without tying you down?

Secretary REGAN. I don't know the precise number, but I do know there's a large amount that can be done.

[The following information was subsequently supplied for the record:]

According to the Grace Commission Report, nearly three-quarters (72.5 percent) of the projected dollar savings require Congressional action if they are to be realized. Another 19.6 percent can be acted on by individual departments and agencies, while 7.9 percent require Presidential action. Thus, somewhat more than one-fourth of the projected dollar savings can be effectuated through executive branch decision making without legislation.

Representative SCHEUER. Right. When are we going to get a timetable of specific changes that the President will be making by executive order, by changing of rules and regulations, within his purview which do not meet the approval or say-so of the House and the Senate?

Secretary REGAN. Well, each of us as Cabinet officers has been charged with putting these into effect in our own departments as quickly as possible. I'm speaking here only for Treasury-only items. I won't commit the other departments. Many of them have to do with either procurement of hardware or software programs that are in the course of action right now and cash management is the big one in Treasury.

We have introduced cash management, electronic funds transfer, lockboxes, and that type of thing in many of our own operations, and we are working with other departments—Agriculture, Interior, and the like—to introduce these into theirs.

It's that type of thing that's on a roll forward type of basis that we actually are putting in. Now the Secretary of the Cabinet, Craig Fuller, is the one that has been charged with keeping the box score. I will ask him for some type of paper to send up to you indicating what the timetable is.

Representative SCHEUER. We would appreciate that very much, the specifics of what the President can do by executive order by changing the rules and regulations, the dollar amounts involved, the kind of action that would be taken, and when they would contemplate taking it, because we are interested in specific action and I'm sure you are, too.

Secretary REGAN. Yes.

[The following information was subsequently supplied for the record:]

A four phase process has been established to ensure that each one of the 2,478 Grace Commission recommendations are thoroughly reviewed.

1. *Initial Review.*—Meetings have been held at the White House to review many of the Task force reports. Representatives from the Grace Commission, relevant Federal agencies, Office of Cabinet Affairs, OMB and the office of Policy Development participated. Consensus was reached to forward recommendations for implementation or hold recommendations for future consideration. This initial review process will continue through the fall of 1984 and be linked to the FY 1986 Budget process.

2. *Final Executive Office Review.*—A final Executive Office review will occur for recommendations where a consensus on implementation could not be reached in ini-

tial review sessions. Such reviews will begin after the initial round of reviews is completed.

3. *Action/Implementation.*—Many of the Grace Commission recommendations already have been implemented. An automated tracking system has been established to ensure appropriate follow-up for all accepted recommendations. Twenty Task Force reports representing 346 of the 784 Commission issues have cleared the initial review process; the 340 issues represent a projected saving by the Commission of $103.5 billion over three years. Of this amount estimated by the Commission, about $40 billion have already been implemented and are in the budget baseline.

4. *Final Status.*—A report detailing the disposition of all recommendations of the 36 Grace Commission Task Forces will be made toward the end of 1985. Updates will be issued periodically during the interim.

Representative SCHEUER. Let me give you the kind of action or inaction that sometimes puzzles us and frustrates us. Last week the Senate agreed that the U.S. Government should subsidize hydroelectric power from the Hoover Dam at a cost of about $3.5 billion over the next decade. Now the Grace Commission itself noted that billions and billions of dollars could be saved if we were to sell energy to utilities at market rates instead of engaging in this subsidy process.

Now this was an excellent example for the Reagan administration to stand up publicly for one of the Grace Commission's major recommendations, but they didn't do it. They supported that subsidy and the Senate passed that subsidy. As I say, rather than support a specific major saving proposal by one of his favorite commissions, the President chose to fly in the face of those recommendations and support the subsidy. You might say the President punted on that one.

Isn't there an apparent contradiction by continuing to support what you would characterize and what I might well characterize as a wasteful status quo when there was a chance here to strike a blow for the kind of economics you have been advocating?

Secretary REGAN. Well, I'm not familiar with the Hoover Dam. I was away last week and I will plead ignorance on that, but I will certainly look into it and try to give you the rationale of what the administration's position was on that one.

[The following information was subsequently supplied for the record:]

The Hoover Power Plant Act of 1984 contained several provisions including the one pertaining to electric power rates. The Act, as enacted, represented an equitable compromise of issues. On the one hand, there is the problem of reversing 50 years of Federal policy based on cheap hydroelectric power. In the case of power generated at the Hoover Dam, nearly two-thirds of the power output is supplied to one State where it is averaged in with other high cost sources of electricity. Any attempt to suddenly raise Federal hydroelectric power rates to market place levels would create a severe hardship on the users in that State who have been receiving the benefits of some subsidized energy.

Although purchasers in California, Nevada and Arizona will not pay market rates for power acquired from the Hoover Dam over the life of the contract extension period, under the Act these purchasers will pay more than operating and maintenance costs because the Act provides that 2½ to 4½ mills per kilowatt hour be added to the rates charged to purchasers in these three States. This is not a true market rate but it is closer to it than the subsidized rate charged in the earlier 50 year contract.

On the other hand, this compromise represents a significant change from past means of financing water projects. The beneficiaries of Hoover power will be required to fully finance the power plant uprating program authorized in this Act, at a cost of $54 million. Also, they will repay with full interest, at the real cost of Federal borrowing, the costs of new recreation and safety facilities.

Secretary REGAN. Let me just say, in general, that it's very difficult, particularly for rural areas and the like where they are used to subsidized energy, to suddenly break away from that habit and start requiring market rates there. And this is particularly true in the Midwest and the Far West, but I'd want to look into that before I answered it.

Representative SCHEUER. Let me just ask you one question in the remainder of my time.

President Reagan has said and you have reiterated that there will be no tax increases in the next fiscal year, in fiscal year 1985. How about fiscal years 1986, 1987, and 1988, which if things break right in November will be on your watch, Mr. Secretary?

Secretary REGAN. Well, let's put it this way, Congressman Scheuer. I've tried to answer this question 17 different ways and I'm not about to get the 18th. I think that's what happened to George Bush the other day. I will merely reiterate that as far as 1985 is concerned, there are no plans for tax increases. Now 1986, we haven't even come to grips with that budget and I don't even know what I'm going to submit for Treasury. So the President has no way of knowing what 1986 looks like, let alone 1987 and 1988.

So all I can say is that we know we are going to get additional revenues from growth and we would hope that we keep the Federal spending down so the deficits will be coming down. But what's going to happen out there, there's no way we can tell that.

Representative SCHEUER. Mr. Secretary, thank you very much.

Senator JEPSEN. I, too, thank you, Mr. Secretary. I thought that our opening question with regard to the secret plan might stave off any prolonged discussion. It didn't. We additionally went into the area of Social Security and got as far as three centuries out and asked for predictions. I would just point out that this is an election year, and I think there are some boundaries of both prudence, responsibility, and decency in rhetoric. I hope that we don't repeat what we did in 1982 when 10 days before the election the President was asked to disclose his secret plan—does that sound familiar—secret plan to take away people's Social Security. That was a pointed plan, and it was a premeditated distortion of facts. It was a cruel hoax and exploited some millions of people in this country, many of whom rely solely on Social Security for the necessities of life. I think that is irresponsible, misleading abuse of our senior citizens and should be soundly rejected at the polls. I predict it will be.

I thank you for your statements and your candor. Could you in a one-liner for each question respond to the following three questions?

First, in your view, what are the most pressing economic problems confronting the Nation today?

Second, when the administration came into office what were the most pressing economic issues?

Third, are today's problems worse or more challenging than the 1981 problems?

Secretary REGAN. In one word? I will submit that for the record, Mr. Chairman.

Senator JEPSEN. Fine.

[The following information was subsequently supplied for the record:]

In my view, the most pressing economic problems confronting the nation today are maintaining the economic recovery, reducing the rate of unemployment, and reducing the growth of government spending.

When the administration came into office the most pressing economic problems were inflation, low economic growth, a slump in productivity growth, falling real income, high unemployment, and government spending that was high and rising faster than GNP.

As the record indicates, the administration has achieved a great deal of success in its economic recovery program, but the challenge to reduce government spending still remains.

Representative SCHEUER. Could I ask for a one-liner, Mr. Chairman?

Senator JEPSEN. Sure.

Representative SCHEUER. One last one-liner. In view of the fact that the 1986 budget is due in January, have you given any thought or is there any preparation now, anything, to lead us to believe that a tax increase might be in the works for 1986?

Secretary REGAN. That's a new way of putting it.

Senator JEPSEN. Thank you, Mr. Secretary.

Secretary REGAN. Thank you very much, Mr. Chairman.

Senator JEPSEN. I now welcome to the witness stand, Mr. William A. Niskanen, a member of the President's Council of Economic Advisers whose ideas are always well reasoned. Mr. Niskanen, we look forward to hearing your testimony. Welcome. You may proceed in any manner you so desire.

STATEMENT OF HON. WILLIAM A. NISKANEN, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. NISKANEN. Senator Jepsen and members of the Joint Economic Committee this is an especially pleasurable time to review the midyear economic outlook. The U.S. economy is now experiencing the strongest recovery in 30 years. Employment has increased 6.4 million during this recovery, a condition that is the envy of the world. The inflation rate is now lower than in any year since 1967. Moreover, current economic conditions and policies suggest that higher than normal economic growth without a substantial increase in inflation can be sustained for some time.

Secretary Regan has effectively summarized the administration's current economic outlook and the general budget conditions. My testimony focuses primarily on current economic conditions, the extent to which these are a result of policies initiated by this administration, and the general implications of these conditions and policies for the future. Only a few people forecast the strength and character of this recovery and, even now, only a few appear to understand why it developed as it did. Any reasoned outlook for the economy must be based on an understanding of the policies that have shaped current economic conditions.

Let us first review three dimensions of the current recovery: Real output and expenditures, employment and real income, and inflation and interest rates.

Table 1 summarizes the sector contributions to the growth of real GNP during the first 6 quarters of the "typical" postwar recovery and during the current recovery. The strength of this recovery is

indicated by the record peacetime growth of real GNP. During the first 6 quarters, real GNP increased at a 5.9-percent annual rate during the typical recovery and at a 7.2-percent annual rate during the current recovery.

[The table referred to follows:]

TABLE 1

Sector Contributions to Growth -- "Typical" and Current Recovery

	First 6 Quarters	
	Typical 1/	Current 2/
REAL GNP (percent annual rate)	5.9	7.2
Sector Contributions (percentage points)		
(1) Personal Consumption Expenditures	3.3	3.8
(1a) Durables	1.0	1.4
(1b) Nondurables and Services	2.3	2.4
(2) Residential Structures	.7	.9
(3) Nonresidential Fixed Investment	.7	1.8
(3a) Nonresidential Structures	.1	.3
(3b) Producers' Durable Equipment	.5	1.6
(4) Change in Business Inventories	1.2	2.0
(5) Net Exports	-.2	-1.5
(5a) Exports	.3	.5
(5b) Imports (3)	.5	2.0
(6) Government	.3	.1
(6a) Federal	-.1	-.0
(6b) State and Local	.4	.1
FINAL SALES (percent annual rate)	4.7	5.1

(1) Average of recoveries from recession troughs in 1954-II, 1958-II, 1961-I, 1970-IV, and 1975-I.
(2) Calculated from 1982-IV recession trough.
(3) Negative contribution to GNP.

Note: Columns may not add due to rounding error.

Source: Council of Economic Advisers.

Mr. NISKANEN. The most striking characteristic of the current recovery is that it has been led by a rapid growth of domestic business investment. Investment in producers' durable equipment, which includes the new machines and computers that incorporate new technology and increase productivity, has been especially strong. Although the change in business inventories has also been unusually strong, the inventory/sales ratio has declined to the lowest level in the postwar years, reflecting strong growth of sales and continued improvement in inventory management.

The only major weak component of the recovery has been a substantial decline in the trade balance. Although exports have increased somewhat more than in the typical recovery, imports have increased at a record rate.

Household spending for nondurables, services, and single-family homes has increased at a rate similar to that in previous recoveries. Total Government spending for goods and services, despite the defense buildup, has been unusually weak. Those who continue to claim that the current recovery has been led by consumer and Government purchases apparently do not read the available data.

Table 2 summarizes the growth of employment and real income during a typical recovery and during the current recovery. Employment conditions through July have been much stronger than through the first 20 months of the typical recovery. Total employment has increased at a 3.8-percent annual rate and total hours worked has increased at an even higher rate. The total number of people unemployed, the unemployment rate, and initial claims have all declined at a record peacetime rate.

[The table referred to follows:]

TABLE 2

Employment and Income -- "Typical" and Current Recovery

	Typical	Current
	(% annual rate)	
Employment Conditions (First 20 Months)		
Total Employment	2.6	3.8
Total Hours Worked	3.4	6.0
Unemployment	-10.2	-18.0
Unemployment Rate 1/	-.8	-1.9
Initial Claims	-17.8	-25.1 2/
Real Earnings and Income (First 19 Months)		
Gross Weekly Earnings 3/	2.7	2.7
Personal Income	5.0	5.2
Personal Income Less Transfers	4.9	6.3

1/ Percentage point change per year.

2/ Based on weekly data through 3rd week in July.

3/ 1970 and 1975 recoveries only.

Source: Council of Economic Advisers

Mr. NISKANEN. Although real gross weekly earnings and real personal income have each increased at a rate close to that in the typical recovery, real personal income less transfer payments have increased at a record peacetime rate. The most important lesson is that the general improvement in employment and real income conditions in this recovery far exceeds the effects of any specific Government measures to increase employment and income.

Table 3 summarizes the changes in prices and interest rates during a typical recovery and during the current recovery. Consumer prices have increased at a 3.5-percent annual rate in this recovery, somewhat higher than during the typical recovery but this rate of increase in consumer prices is much lower than in any year since 1972. Producer prices have increased at a slower rate than during the typical recovery, reflecting in part the effects of the large increase in the exchange value of the dollar.

[The table referred to follows:]

TABLE 3

Prices and Interest Rates --"Typical" and Current Recovery

	Typical (% annual rate)	Current
Price Indices (First 19 Months)		
Consumer Price Index	2.3	3.5
Producer Price Index	1.7	1.2
Interest Rates (First 20 Months) 1/		
Treasury Bill Rate	.4	1.2
10-Year Bond Rate	.2	1.7

1/ Percentage point change per year.

Source: Council of Economic Advisers

Mr. NISKANEN. Interest rates have increased more rapidly during this recovery and, until the past 2 months, long rates have increased more rapidly than short rates. Since the 1st of June, however, the yields on long-term Government bonds have declined by more than 1 percentage point, suggesting that long rates may have peaked and that the market may be increasingly recognizing the commitment of the administration and the Federal Reserve Board to avoiding a reacceleration of inflation.

More important to discuss this morning, since these data are available to all the world, is to address how did all this happen? What explains the strength of the current recovery? What explains the rapid increase in domestic business investment, despite unusually high real interest rates? What explains the relative strength of the dollar, despite a large trade deficit? What explains the dramatic decline in the inflation rate since 1980? To what extent are these conditions a result of policies initiated or supported by this administration?

First, it is important to strip away some of the myths about the current recovery. Contrary to the perspective of those who view the economy through a Keynesian lens, this recovery has not been fueled by the large Federal deficit. If that were the case, the rate of growth of money velocity would be unusually high; in fact, it has been unusually low. In addition, a Keynesian recovery would be characterized by an unusual growth of consumer spending on Government purchases; in fact, the current recovery has been led by domestic investment. The strange, directly contrary view that the deficit will abort the recovery has no basis in either theory or evidence. The budget totals, in fact, provide little useful information about the effects of the budget on the economy; a wide range of economic conditions is consistent with the same budget totals. Most of the economic effects of the budget depend on how the detailed characteristics of Government spending and the Tax Code affect the output or supply side of the economy.

The assertion that real interest rates are high primarily because of the large deficit, a view shared by both Keynesians and many financial analysts, should now be recognized as clearly wrong. If that were the case, investment would be unusually weak; in fact, domestic business investment is unusually strong. The condition of high real interest rates and strong investment indicates that an increase in the demand for investment, rather than a reduced supply of net saving, is the primary cause of the high real interest rates. Economic theory, with one exceptional case, leads most of us to believe that Government borrowing, by reducing the net saving available for other uses, almost surely has some effect on interest rates, although the evidence for this relation is somewhat less than underwhelming.

Finally, all too many people have been grumbling that economic growth is too high, that it will lead to increased inflation. What rubbish! Maybe a psychologist can explain this "good news is bad news" attitude, but I cannot. An increase in output, by itself, of course, reduces prices. The proper issue to address is whether total demand is growing more rapidly than is consistent with a stable inflation rate, and that has been the case to date. Our responsibility is to maintain a steady and sustainable path of key policy varia-

bles. We welcome the highest rate of output growth that is consistent with these policies.

After stripping away these myths, what explains the distinctive characteristics of the recovery—strong investment, high real interest rates, a strong dollar, a large trade deficit, and a substantial reduction in inflation?

Our perspective on these conditions is somewhat different from the conventional perspective but, I believe, is more consistent with the combination of these conditions. Both the strength and the composition of domestic business investment is a consequence of the combined effect of the depreciation provisions of the 1981 tax law, the reduction of inflation, and the general strength of the recovery. The first two conditions—the accelerated depreciation allowances and a decline in inflation—as explained in the 1982 Economic Report, substantially reduced the effective tax rate on new domestic business investment and, thus, increased the real after-tax return on investment in the United States.

This increase in the return on investment in the United States relative to that in other countries, in turn, is the primary reason for the continued strength of the dollar. The large trade deficit is a consequence of the combined effects of the strong dollar and the relative strength of the U.S. recovery. And the current account deficit, in turn, reflects the capital inflow necessary to finance the difference between our strong domestic investment and the total saving net of the Federal deficit.

Our general explanation of these conditions differs from the conventional explanation primarily in the role that it attributes to the depreciation provisions of the 1981 tax law rather than to the deficit. Our perspective is that the Federal deficit has not been the primary influence on interest rates or the exchange rate but that it has probably affected the magnitude of the trade deficit and the current account deficit.

The final condition that requires explanation is the substantial reduction in inflation. The sharp reduction in money growth through mid-1982 was clearly important but, in fact, inflation has declined much more than can be explained solely by monetary policy. Our judgment is that the strong increase in the dollar, in response to the increase in the after-tax return on investment in the United States, has made a major and continuing contribution to the reduction of U.S. inflation. This effect first operates on the price of goods that are traded in international markets and, over a longer period, also reduces the inflation on untraded goods and services. Contrary to the conventional explanation that monetary and fiscal policy have been operating at cross purposes, both of these policies, I believe, have contributed to a strong investment-led recovery and a continuing reduction in inflation.

Finally, what are the general implications of these conditions and policies for the economic outlook?

For the most part, current conditions and policies support a forecast of continued higher than normal growth and low inflation. Domestic business investment is likely to stay strong, unless we make the mistake of reversing the business investment incentives in the 1981 tax law or the mistake of a substantial increase in inflation. Real interest rates and the dollar may decline only slowly. Mone-

tary policy has been on a relatively stable and sustainable path since mid-1983, and the full effect of the strong dollar on the U.S. inflation rate, I believe, have yet to be realized. Conditions in the real economy indicate only selective capacity limits, some of which are the result of trade restraints. So inflation is likely to stay low for the near future.

Some recent economic indicators have weakened but I believe are likely to be reversed. The reported decline in the index of leading indicators for June was followed by a record 1-week increase in the stock market, which will lead to a strong increase of the leading indicators for August. The reported increase in the unemployment rate for July appears on close examination to be the result of an inadequate seasonal adjustment procedure, and that increase is likely to be reversed somewhat in the next report. At some time, the economy will shift from the high growth path of the early part of recovery, but we do not yet have any clear signals from the available data of a substantial reduction in economic growth or an increase in inflation. Our judgment is that U.S. economic conditions will continue to be more favorable than those forecast by most economists, many of whom do not appear to understand either the strength and character of the recovery to date.

Thank you.

Senator JEPSEN. Thank you, Mr. Niskanen.

I just have three questions for you. I will take them one at a time.

In your view, what are the most pressing economic problems confronting the Nation today?

Mr. NISKANEN. The most pressing fiscal problem is to reduce the Federal deficit, but it is also very important about how it is reduced. The economic consequences of reducing the deficit will depend very strongly on the particular measures that are chosen to reduce the deficit and the consequences of reducing it by spending restraint and economic growth will be far more favorable than measures that increase tax rates, particularly those tax rates on business investment.

So the most pressing early problem we have to resolve is to reduce the Federal deficit and preferably by the combination of spending restraint and economic growth.

Senator JEPSEN. To examine this problem a little more closely, how fast must this deficit be reduced? We will be talking about a balanced budget amendment here. We are talking about interest rates being too high and many people believe that you must balance the budget next year. Would you just comment on the reduction of deficits?

Mr. NISKANEN. Senator, the sooner the better if it is done correctly. We should recognize that the economic consequences of the deficit are like a slowly acting, but potentially lethal, cancer, but they do not lead to dramatic effects in the short run. If that were the case, there would be no problem of energizing this town to do something about the deficit now. All too many of us for too many years have acted in the spirit of St. Augustine's prayer—"Lord, make me virtuous, but not yet."

We should recognize that we have to address the deficit and the sooner the better if it is done correctly, but that it is not the type

of condition that will lead to dramatically unfavorable effects in the near future.

Senator JEPSEN. Technically, constitutionally, I don't think there's any—there shouldn't be any question in anybody's mind about where the responsibility for Government spending rests. Constitutionally, it is a power and responsibility delegated to Congress. It's spelled out that they shall have the power to appropriate funds and levy taxes which says it all.

Although it may be constitutionally, legally, and technically correct, is it in fact a practice that the Congress has the sole responsibility to take the complete credit or blame, depending on how you want to call it—whatever you want to call it—for the deficits?

Mr. NISKANEN. Senator, I think that there is enough blame to be spread rather widely. The Constitution clearly gives the Congress the authority to raise money and to determine the allocation of spending. But since the early part of this century, Congress has requested a budget plan from the President and has, in effect, delegated or shared some of its responsibility with the President. And I think that for that process to work effectively, both the President and the Congress must accept their responsibility for this process and face up to the major issues that have to be addressed.

The fundamental difference of opinion on this matter is not whether the deficit should be reduced or even about how much. I think that there's a general recognition across parties on that matter.

The fundamental difference is whether we balance down to the level of revenues generated by our present tax system or whether we tax up to the level of spending that Congress has now approved. And that is fundamentally a political choice and, as an economist, we can advise about the consequences of that choice, but the fundamental political issue is how big a Government we want in the United States.

My personal preferences are strongly consistent with those of the President. To the extent possible, we should balance down.

Senator JEPSEN. Are we in a catch-22 situation now that the President has submitted a budget? Is that correct?

Mr. NISKANEN. There is an outstanding budget proposal for fiscal year 1985 and Congress is acting on that.

Senator JEPSEN. But that has been submitted?

Mr. NISKANEN. That was submitted at the end of January.

Senator JEPSEN. But it isn't being acted on by Congress, and he's forcing them to submit their own?

Mr. NISKANEN. Congress is working on it. The Congressional budget process has not worked with great speed in recent years, but many important actions have been taken and I'm pleased that at least part of the downpayment package has already been approved and signed. I hope that Congress is going to address soon the other important spending restraints that were part of the original downpayment agreement.

Senator JEPSEN. It was part of the original agreement. I note that the President in his State of the Union Message indicated this year that some of the same things that you alluded to here—that if you wanted to try to blame somebody for something, there's plenty

of blame to go around which wouldn't accomplish anything. Then, he continued to say that on a bipartisan basis, without fear or favor, they should get together with Congress to provide for a plan to make a downpayment which is a commonsense sort of way of expressing it. Subsequently, we had much wailing, gnashing of teeth, sloganeering, and quarreling of one budget over another. Now we have come out with individual budgets, both Republicans and Democrats. But as it came about, it went full circle, coming to the point which the President indicated it should be when he made his statement, that is, we get together and make a downpayment.

The first part of that agreement has been accomplished. I was somewhat surprised to see the President sign it because the last time it was presented to him with the indication that there was going to be a 3-for-1 tax cut if he signed the first part which, of course, was not forthcoming and did not ever transpire. So to use the old proverb: "Do this to me once, shame on you; do this to me twice, shame on me"—I thought maybe that was what the President would do. But in good faith, he didn't, and I hope the Congress will follow through.

When the administration took office, what, in your opinion, were the most pressing economic issues?

Mr. NISKANEN. At that time we faced extraordinarily high inflation very sluggish productivity growth, and a generally pessimistic outlook about the economy. Most of those conditions have been reversed dramatically in the last several years.

There should be a general recognition of the improvement in economic conditions and reduction of the problems that existed as of January 1981.

As the years go on, of course, we face different problems and we should not rest on our laurels, but we should go on and address the problems that remain.

There is one major policy and one major component of the economy that are clearly not on a sustainable path. The budget deficit is too high to be sustained, and the current account deficit in our trade accounts is too high to be sustained. Those two conditions may be related, in that reducing the Federal deficit may have an effect of reducing the current account deficit as well. We need to address the matters that bear on both of these deficits.

Senator JEPSEN. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Thank you for your testimony. I thoroughly enjoyed it.

Secretary Regan testified as to the optimistic deficit estimates which he has forecast and which I presume was prepared in collaboration with the CEA. These deficit forecasts through 1989 critically depend on the reduction of interest rates. And he testified that if the Congressional Budget Office is right in their estimate that interest rates will come down to 8.7 percent instead of 5.1 percent by 1989, it will make a difference of about $78 or $80 billion in 1989 alone.

Now, assume arguendo that they are right. It's always possible. When would you begin to know that and when would you begin to read the tea leaves and what kind of action would you then begin to think that a tax increase might be indispensable and when would that likely to become apparent?

Mr. NISKANEN. Congressman, an economist should not be making a judgment about whether a tax increase is necessary. That is fundamentally a political judgment about whether a tax increase is necessary to reduce the deficit.

We have every reason to conclude that the deficit must be reduced. But whether that is reduced by spending restraint or a tax increase is fundamentally a political decision of whether spending can be reduced and whether it is desirable to reduce spending growth. And we will not know well into 1986 or 1987 whether the interest rate path in the CBO forecast or the administration's forecast is more accurate, but we should not wait until that time to address the deficit.

Representative SCHEUER. Let me ask you, as an economist, is there any precedent for a forecast of 4-percent growth, declining interest rates, and declining inflation, which are the intellectual tripod, let us say, of this deficit reduction?

Mr. NISKANEN. Congressman Scheuer, we had a 5-year period in the mid-1960's with more than 4 percent growth.

Representative SCHEUER. That's true.

Mr. NISKANEN. That followed similar economic policies, initially, a reduction in business taxation followed by a reduction in personal income tax rates, with the differences that the Kennedy administration started with a low inflation rate and with a budget that was in good shape. We started with a very high inflation rate and a budget that was already out shape.

There is ample historical evidence that suggests that a period of growth at this rate can be realized, and I think there's reason to believe that that period of growth during the 1960's was a consequence, in large part, of the same kind of policies that we have put in place.

Representative SCHEUER. So, as an economist how would you characterize the economic forecasts?

Mr. NISKANEN. They are assumptions that are premised upon the continuation of the key economic policies that are in place now and, in part, are premised upon actions that have yet to be taken to bring the budget under control.

Representative SCHEUER. Actions such as what, from an economist's point of view?

Mr. NISKANEN. We are more likely to realize these forecasts if we address the budget deficit by spending restraint rather than by tax increases. A tax approach toward resolving the budget deficit may very well destroy this forecast.

Representative SCHEUER. Mr. Niskanen, you have given us a very lucid explanation of an economist's posture that you would rather balance the budget by spending down rather than taxing up. My goodness, we all would. But don't you begin to get some sense of the realities of the situation with which Congress has to deal and across party lines when the leaders of the Republican Senate in effect say there isn't any room for further cuts in either discretionary nondefense spending or in the entitlements program?

I want to express here my extraordinary admiration for Senator Dole and Senator Baker and other leaders of the Republican Party in the Senate for their total responsibility. I think we can be proud of the Congress as an institution. Perhaps we should have done

more, but I think there's been a minimum of demagoguery on this issue and I think there must be some lessons that you can take from the fact that nobody over here has come up with significant spending cuts above and beyond what our chairman talked about as the downpayment. We scraped the bottom of the barrel to come up with spending cuts. And if he knows of any others that we ought to be taking now or if my distinguished colleague from the House knows of any, I'd be happy to yield my time to them.

But your job has to be more than just a pure economist job. You're not in an ivory tower at Harvard, Yale, or Princeton, nor were you on the Ford Motor Co. where you performed with great distinction. You had a certain economic realism and pragmatism there. And the same requirements fall on you here.

We are all restrained by what is doable. This is the art of the possible that we are working with here. Ideally, of course, we would reduce spending rather than taxing. None of us like to go back to our constituents and talk about tax increases.

When I stand at the subway in the morning and I shake hands with people going to work, I have about half a second with each one of them, and their one message to me is, "Congressman, don't raise our taxes," and then they disappear down that cavernous black hole. And it's the same at the plant gate in Grand Island, NE, as it is at the subway entrance in Manhattan.

I'm trying not to let you get away completely by saying, well, we want to reduce spending, or we want you to spend down and tax up. What can you recommend to the Congress now? The Senate and House, Republicans and Democrats, we're all in this together. We are all pleased that the economy is improving, as I said before. We only have one country and I don't think there's a Democrat alive who wishes this country were in a deteriorating economic condition. What do you think we should do now?

Mr. NISKANEN. I think the first order of business is to pass the rest of the downpayment package. We had proposed and had a general agreement for what I call a 10-percent downpayment and we got 7 percent downpayment. Let's get the rest of the package between now and the election day so that all of us can say that we've made a start on this matter.

One of the sad things that happens in this town, as you realize, is that realism destroys idealism, and I hope——

Representative SCHEUER. Well, you have to make three exceptions to that in the House and the Senate. They all happen to be here today. We are all three of us confirmed idealists, although we try to be pragmatists too.

Mr. NISKANEN. I'm pleased to hear that. I do not want to take as a given that spending cannot be reduced. I think that it would be best to have people in the budget process who don't take that as a given; in other words, people who believe, maybe contrary to all the political signals they are getting, that spending can still be reduced or at least constrained in growth.

The deficit is now of sufficient magnitude that I think we have to have a bipartisan agreement on how to address this matter. It's not going to be an issue that can be sorted out on party lines. And I am pleased that there is, as far as I can tell, significant difference of views on whether or even much how much the deficit should be re-

duced. Let's sort out this continuing and very important question of how to reduce it.

Representative SCHEUER. Do I have time for one more question?

Senator JEPSEN. Representative Snowe yields.

Representative SCHEUER. OK. Mr. Niskanen, in 1980 in those dim distant years before you came to Washington, you wrote an article entitled "A Friendly Case Against the Balanced Budget Amendment." I'm asking you a friendly question.

Does this article reflect your current point of view and do you therefore oppose the balanced budget amendment?

Mr. NISKANEN. That article was written to make the point that the proposal for a balanced budget amendment by itself would not be sufficient to discipline the primary problem, which is the total resource claim of the Government. At that time I was one of the founders of the National Tax Limitation Committee, out of which came proposition one in California and similar amendments in Michigan, Tennessee, Missouri, and elsewhere.

Our organization at that time was sponsoring a tax and spending limiting amendment, not specifically balanced budget amendment, which we believed then and I believe now is more important than a balanced budget per se.

In 1982 the Senate wisely asked the National Tax Limitation Committee and the National Taxpayers Union to get together on an amendment that included both a balanced budget and a spending limit, and Senate Joint Resolution 58 was the outcome of that process. I strongly support that specific proposal.

I continue to believe that a limit on the total spending and taxing authority of the Federal Government is more important than a balanced budget per se, but the amendment that came out of those Senate deliberations was well crafted and would be an important amendment to approve.

Representative SCHEUER. Thank you very much. I really appreciate your testimony. It's very, very impressive.

Thank you, Mr. Chairman.

Senator JEPSEN. Congresswoman Snowe.

Representative SNOWE. Mr. Niskanen, in your testimony you mentioned that "Our judgment is that the U.S. economic conditions will continue to be more favorable than those forecast by most economists."

How long do you believe we can sustain this recovery without making any adjustments to the deficit?

Mr. NISKANEN. The deficit will continue to distort the composition of the recovery, most importantly, I believe, affecting investments outside the business community—housing, State and local investment, and the U.S. investment position abroad. That distortion should be corrected. but, by itself, isn't going to abort the recovery.

So I don't think our forecasts of the general development of the economy are terribly dependent upon how fast the deficit is reduced, but a reduction in the deficit can clearly reduce some of these existing distortions.

Representative SNOWE. Well, how much do you think is necessary?

Mr. NISKANEN. The first priority for reducing the deficit is to assure that the outstanding debt does not grow more rapidly than nominal GNP. At the end of fiscal year 1983 privately held Federal debt was a little less than $1 trillion and nominal GNP had grown about 9 percent. That would suggest that we need to get the deficit down, as an initial target, to the $100 billion range, just to make sure that the debt does not grow relative to the level of the national economy. And beyond that, the question is how much we want to affect these components of the economy that may have been weakened by the deficit, most importantly, I think, investments outside the business community and U.S. investment abroad.

Representative SNOWE. At what point do you think that the deficit affects interest rates?

Mr. NISKANEN. My sense is that the consequence of the deficit on interest rates is a good bit larger than what the data show. Most of us are operating on theory in this regard, and deficits almost surely must have some effect on interest rates. But a review of 17 studies by the Congressional Budget Office, those plus another dozen that we have reviewed, finds surprisingly little evidence of the effect of deficits on interest rates. That does not deny its effect. It's just that maybe our statistical techniques are not sufficiently refined or that other phenomena overwhelms the effects of the deficit.

My testimony today suggests that the deficit may have had some effect on interest rates in recent years, but it's quite clear that the dominant effect has been operating through an increased demand for investment and not a reduced supply of saving. If it were the deficit that is driving interest rates, we would have low investment, not high investment; and right now we have unusually strong investment.

Representative SNOWE. Finally, do you believe in the crowding out syndrome?

Mr. NISKANEN. Yes. I think crowding out is a more or less continuous phenomenon. We have to address two dimensions of it. The best measure of the total crowding out of the Federal Government is total Federal spending. Whether we finance it by taxes or by borrowing will affect the composition of what is crowded out, but the total crowding out is measured by total outlays.

I believe that the deficit has a crowding out effect on domestic investment more or less continuously in good times and bad times, although not on a dollar-for-dollar basis because some of its effects are on other sectors.

Representative SNOWE. Don't you think that could have an effect on the interest rates?

Mr. NISKANEN. As I said, I think it very likely does have an effect on interest rates, but it is painfully difficult to find it in the data.

Representative SNOWE. Do you concur with Secretary Regan about economic growth reducing the present levels of the deficit?

Mr. NISKANEN. Yes, it clearly will, and the more growth the better. Within the plausible range of economic growth, the deficit will not fall sufficiently. So we need something more than growth. And the President's clear strategy and my continued advice is that we reduce it primarily by growth and spending restraint.

Representative SNOWE. How important has consumer spending been to this recovery?

Mr. NISKANEN. Consumer spending has been roughly on track with that of prior recoveries. The one component that has been a little bit higher than usual has been automobiles, but most of consumer spending has been roughly as strong as in previous recoveries.

Representative SNOWE. Thank you, Mr. Niskanen.

Senator JEPSEN. Mr. Niskanen, what are the forecasts for the economic condition of small town U.S.A.? Are rural areas joining in the recovery?

Mr. NISKANEN. One of the big changes indicated by the 1980 census is that rural America is growing relative to the size of the total population for the first time in decades. These are people who live and work in rural areas, but other than people in the farming community. There is a wide divergence among rural areas about how well they have done during this recovery. You find in the State of Nebraska, for example, an unusually low unemployment rate—I believe the lowest in the country—associated with weakness in a number of key farm sectors. So you can find big differences in economic conditions even within the same State and big differences among rural areas across the country.

I don't know of any data that bear on the question of how small towns in rural America have done during this recovery in general relative to people who live in major cities. One condition that I expect over a longer period of time is that one effect of computer and telecommunications technology will be to reduce the economies of big cities and make it easier for people to live where they want to live and maintain competitive production.

Senator JEPSEN. In my State of Iowa many rural areas have not shared in the dramatic economic recovery. We have had some very serious straits, much of it due to the whiplash sort of situation from international competition in agriculture in the 1970's; the subsequent pyramiding of assets to use as a source of collateral for borrowing and extended credit; and the combination of the dramatic drop in inflation and the recession. Frankly, the grain embargo that we entered this decade with has been devasting economically in rural areas. At this time farmers continue to have some difficult times, and I think we need to be both sensitive and perceptive in informed assistance, guidance, and understanding.

There has been some concern that Washington has not been as sensitive and perceptive as they should. And if they haven't been, I would share some of the blame because I haven't told the story well or often enough, which I'm putting in the record one more time right now as part of that responsibility and concern.

Mr. NISKANEN. I think we share both your concern and your understanding of the problem. Most of the problems have arisen to those people who bet on inflation and who borrowed heavily in the late 1970's. One of the major accomplishments of this administration and the Federal Reserve Board in the last several years has been a dramatic reduction in inflation. We have no reason to apologize for that. People who bet on inflation have lost a lot of money. That can be a matter of concern and sympathy and understanding,

but we should not affirm their prior expectations which proved to be wrong.

Many of us have made bad investments at one time or another in our lifetime. I think we should be careful about accepting any Federal responsibility to confirm the initial expectations on which people make their investments.

Senator JEPSEN. Congressman Scheuer.

Representative SCHEUER. I have one more question, Mr. Chairman.

Mr. Niskanen, we have an expression in politics, "Would that mine enemy would write a book?" You have been a very prolific writer. I'm going to ask you one more question.

You were quoted in the December 9, 1981, New York Times as saying the following: "The initial elements of the Reagan economic package of tax cuts, much more military spending, slower inflation and a balanced budget by 1984, were mutually inconsistent."

Now in effect you were saying that this package——

Senator JEPSEN. May I interrupt?

Representative SCHEUER. Sure.

Senator JEPSEN. Would you mind adjourning the committee? I do have a vote in the Senate, and it's a cloture vote dealing with the budget resolution, so I should go.

Representative SCHEUER. I would be happy to, Senator, right after this question.

Senator JEPSEN. I thank you, and I thank you, Mr. Niskanen.

Representative SCHEUER. Now wouldn't the parallel logic today be that we have an inconsistent set of intellectual props for the President's current posture on budget spending matters? His package is a refusal to consider tax increases, a refusal to consider decreases in the military budget, while all along maintaining that he's going to continue to decrease the deficit and continue to control inflation and continue to reduce interest rates.

Now do we have the same incompatibility here under these four—do we have the same inconsistencies in effect prevalent today in the President's posture as we had in 1981 in December when you made that thoughtful, perfectly logical comment?

Mr. NISKANEN. It's quite clear that we either have to reduce spending growth or increase tax revenues if we're going to reduce the deficit. That's a matter of arithmetic and is not a very subtle point.

I don't think we should take as given the "realism" of Washington that we can't reduce spending. Of course, once you start blocking off whole sections of the budget and saying you can't reduce that, the problem gets more difficult. And given the magnitude of the deficit, I think we should be willing to have a thorough scrub on every component of the budget, and I think there are potential savings and economies in almost every component. Even where we have an unconditional obligation to pay, such as interest payments, there are some measures that might be effective in reducing such payments.

So there's no way to say whether the posture is inconsistent until the details are spelled out, and then we can check the arithmetic.

The President has articulated a clear strategy for reducing the deficit. That strategy is viable and is consistent with the best economic conditions in the country. Whether it turns out to be politically realistic depends in large part on what happens on Capitol Hill.

Representative SCHEUER. Well, I think that's a good note to close this testimony on. It certainly hasn't been realistic in an election year because I haven't seen any initiatives on either side of the line in either party and that's stating it loud and clear in a very nonpartisan way. The Congress just can't cope, can't grapple with the order of magnitude of deficit that we are now having in a Presidential election year when all of the House and a third of the Senate is also up for reelection. And that's why we put it off a year.

Mr. NISKANEN. But let's complete the downpayment package.

Representative SCHEUER. I quite agree with you.

We very much appreciate your very highly thoughtful and very frank and forthright testimony. Thank you very much, Mr. Niskanen.

[Whereupon, at 12:10 p.m., the committee adjourned, subject to the call of the Chair.]

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